EARNOUTS IN M&A TRANSACTIONS

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CHOICE, GOVERNANCE & ACQUISITION OF ENTITIES

STATE BAR OF TEXAS CLE PROGRAM

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1. INTRODUCTION

An "earnout" is a deal mechanism used in a merger and acquisition transaction ("***M&A Transaction***") which structures the terms upon which a buyer agrees to pay additional consideration to the seller after the closing of the M&A Transaction if certain specified performance targets are achieved post-closing by the acquired business or upon the occurrence of specific events.[1] An earnout is a particularly useful deal mechanism when the buyer and seller have differing views on the value of a business, which often is based on the estimated future performance of the business or the likelihood that a specific event will occur in the future related to the acquired business. Earnouts are also commonly used in a number of other scenarios, such as where: i) the seller will remain involved in the business post-closing and the earnout is intended to incentivize the seller to continue operating the business in a profitable capacity or grow the business for the buyer's benefit after the closing of the M&A transaction; ii) the acquired company has little operating history but significant growth potential as a result of the M&A Transaction; iii) the acquired company now has access to new technology which may increase its profitability or value; iv) the acquired company experienced a drop in earnings prior to the M&A Transaction which the seller thinks is temporary; or v) the acquired company is operating in a volatile economy or industry which can adversely affect the acquired company's profitability or cause its value to fluctuate widely.[2]

While earnouts are used to bridge disagreements which arise during the negotiation of the purchase price, earnouts commonly result in post-closing disputes over the calculation of the earnout. These disputes often lead to litigation, arbitration or mediation. To reduce the risks of such issues, it is critical that the buyer and seller bargain for and agree to specific and deal-contextualized provisions and procedures relating to the calculation of the earnout, the parties'

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[1] Practical Law Company, 'Earn-outs' (2010).

[2] *Id*.

respective earnout-related obligations, and the mechanism to dispute the calculation of each party's earnout-related obligation.[3]

In 2018-19, the American Bar Association M&A Committee reviewed a sample of 151 acquisition agreements with a transaction range of $30 million to $750 million. [4] Out of the 151 acquisitions, approximately 27% of those deals included some kind of earnout provision, and approximately 60% of all of the earnouts had the earnout calculation based on either Revenue, Earnings or EBITDA of the acquired business.[5] The use of earnouts in private target deals has steadily increased since 2006, with a dramatic increase in use during the 2008 financial crisis.[6]

Earnout provisions are often incorporated in the body of the acquisition agreement, but can be included in a separate earnout agreement. Attached as Exhibit A is a form of separate Earnout Agreement.

2. ADVANTAGES AND DISADVANTAGES OF EARNOUTS

Earnouts have advantages and disadvantages for both the buyer and the seller in an M&A Transaction. The seller prefers the earnout because it provides an opportunity to get a higher purchase price for the acquired company than it would have otherwise been received in the transaction. Without the earnout, the price the buyer would be prepared to pay for the potential acquisition may be discounted as a result of doubt as to the future profitability or value of the acquired company.[7] An earnout is particularly helpful for a distressed seller who may have no other choice than to sell as the earnout provides the distressed seller with immediate cash at the closing of the transaction while also preserving the opportunity to recover some of the potential upside of the sold company via the potential of a future payment via the earnout. Earnouts also benefit the seller by allowing the seller an opportunity to benefit from the synergies achieved by the acquired company as it is integrated with the buyer's existing business.[8] These synergies may cause the acquired company to perform at higher levels than it previously did when it was owned by the seller and result in a greater earnout payment from the buyer to the seller.[9]

An earnout can also benefit the buyer of the acquired company as it provides a protection mechanism against overpayment as a result of adjusting the total purchase price based on the actual performance of the acquired company and not solely on the future projections and

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[3] *Id*.

[4] American Bar Association, Business Law Section, *Private Target Mergers & Acquisitions Deal Points Study (Including Transactions from 2018 and Q1 2019)*, https://www.americanbar.org/digital-asset-abstract.html/content/dam/aba/administrative/business_law/deal_points/2018_private_study.pdf (last visited May 6, 2020).

[5] *Id*.

[6] *Id*.

[7] Practical Law Company, *supra* note 1.

[8] Gail Weinstein, Robert C. Schwenkel, and David L. Shaw, *The Enduring Allure and Perennial Pitfalls of Earnouts*, Harvard Law School Forum on Corporate Governance, Feb. 10, 2018, https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/.

[9] *Id*.

predictions of future performance. The earnout also benefits the buyer by deferring payment of part of the total purchase price until a specified time after closing. This allows the buyer to use some of revenues of the acquired company to pay for part of the consideration for the acquisition of the acquired company.[10] This is particularly beneficial for private equity buyers when credit markets and debt financing options are limited and interest rates are high. Deferring part of the total consideration until after closing reduces the buyer's dependency on third party lenders and financing as less capital is required up front and the buyer is able to use the revenues and proceeds of the acquired company to pay some of the earnout amount.[11] The earnout also apportions the risk and rewards of the acquired company's future performance and earning potential between the buyer and seller, which alleviates some the risk the buyer experiences in purchasing the company. If the seller will continue to manage or operate the acquired company post-closing, the earnout incentivizes the seller to continue to operate the company in a way which maximizes its profitability. The buyer will also benefit from the earnout as an offset mechanism to fund future indemnification claims under the purchase agreement and as a mechanism to outbid other possible buyers if the company is being sold in an auction process.[12]

Earnouts often present disadvantages for both the buyer and the seller such as the profitability of the acquired company can be affected by many factors unrelated to the acquisition, the company's performance or intrinsic value, which may work to the advantage or disadvantage of either party. Earnouts often lead to disputes between the buyer and seller post-closing and these disputes are routinely associated with the buyer and seller disputing how, when and if the financial targets were achieved or how to measure the Company's performance.[13] These disputes can be avoided or dissipated with careful drafting and negotiation of the earnout provision; however, such drafting and negotiating is difficult and will require additional time and cost from the legal team. Additionally, a complex earnout provision may require significant accounting and financial statement analysis which typically requires an outside accounting and financial team.[14] These additional legal and accounting costs can be the responsibility of the buyer, seller or shared between the parties. Lastly, earnouts require intense post-closing monitoring and measuring of the acquired company's performance. It is possible that time and cost spent on monitoring the earnout metrics and performance will distract both parties (particularly the buyer and the acquired company's management team) from effectively running their other businesses.[15]

3. EARNOUT STRUCTURE AND TERMS

The *Tutor Perini*[16] decision demonstrates how a typical earnout is structured in an acquisition and also demonstrates some potential problems which can arise between the buyer and seller regarding the earnout. In 2011, Tutor Perini Corp acquired GreenStar Services, Inc., and its

[10] *Id*.

[11] *Id*.

[12] *Id*.

[13] *Id*.

[14] *Id*.

[15] *Id*.

[16] *GreenStar IH Rep, LLC v. Tutor Perini Corp.*, WL 5035567 (Del. Ch. 2017).

various subsidiaries, for approximately $208 in consideration. The acquisition agreement included an earnout, which required Tutor to pay the GreenStar Representative 25% of GreenStar's yearly "Pre-Tax Profit" in excess of $17.5 million, with a cap of $8 million for each year, for a period of 5 years.[17] Any excess amount not paid due to the $8 million cap was to be applied as a credit to any future payments which fell short of the cap.[18] The agreement also required Tutor to calculate the Pre-Tax Profit within a specific amount of time after the end of each company fiscal year and provide the Pre-Tax report to the GreenStar Rep.[19] The GreenStar Rep would then review the Pre-Tax Report and if the GreenStar Rep accepted the Pre-Tax Report, Tutor was required to pay the earnout amount calculated.[20] If the GreenStar Rep did not accept the Pre-Tax Report, then the two parties were required to attempt to resolve the dispute arising out of the Pre-Tax Report for a specific time period, and, if they could not resolve the dispute, then the parties were required to submit the dispute to a neutral accountant to resolve the dispute.[21]

The two years following Tutor's acquisition of GreenStar went without issue and GreenStar accepted the Pre-Tax Report and the earnout amount paid was the $8 million cap.[22] A total excess of $9.2 million was carried forward for possible payment in future years if the earnout amount from such future years did not reach the $8 million cap.[23] The third and fourth years after closing are where the issues began to arise between Tutor and the GreenStar Rep. For both the third and fourth year after closing Tutor prepared the Pre-Tax Report and delivered it to the GreenStar Rep.[24] However, Tutor refused to pay the earnout amount calculated in the Pre-Tax Report claiming that it believed that the individual who was entitled to receive the largest share of the earnout payments from the GreenStar Rep had been providing fraudulent information to Tutor which incorrectly raised the amount of Pre-Tax Profit (and, therefore, the earnout amount due to the GreenStar Rep from Tutor).[25] In the fifth year post-closing, Tutor did not prepare a Pre-Tax Report or make any earnout payment to the GreenStar Rep.[26]

Vice Chancellor Slights held that the acquisition agreement established the exclusive mechanism for challenging the financial statements upon which the earnout was required to be calculated, and did not allow Tutor to withhold earnout payments even if it later found reason to believe the information used to calculate the Pre-Tax Report was inaccurate or inflated.[27] Vice Chancellor Slights pointed out that the parties had accepted to the report in the years that the earnout payment was calculated, and, thus, the earnout payment was due each year. The contractual basis of the opinion was explained as follows:

[17] *Id*. at *1.

[18] *Id*. at *1-2.

[19] *Id*.

[20] *Id.*

[21] *Id.* at *3.

[22] *Id*.

[23] *Id*. at *3-4.

[24] *Id*.

[25] *Id*. at *3-4.

[26] *Id*.

[27] *Id*.

“When interpreting a contract, I am bound by the language within the contract unless that language is ambiguous. Stated differently, “the role of a court [in contract construction] is to effectuate the parties' intent. In doing so, [the court is] constrained by a combination of the parties' words and the plain meaning of those words ....”

The Merger Agreement, at Section 2.14(a), spells out unambiguously how the Earn–Out Payments for each of the five Earn–Out Years are to be calculated. This calculation is expressly dependent upon Tutor Perini's calculation of Pre–Tax Profit as disclosed in its Pre–Tax Profit Reports. At Section 2.14(b), the parties evidenced their intent to streamline the Earn–Out Payments by agreeing to a process by which they would settle earn-out related disputes in an expedited and extra-judicial manner. If the parties do not invoke this process, then “[t]he Pre–Tax Profit Report ***and*** the Pre–Tax Profit for the twelve-month period reflected [on the report], ***shall be binding*** upon the Interest Holder Representative, Stockholders ***and Parent***.” Thus, reading Section 2.14(a) and Section 2.14(b) together, the terms unambiguously provide that the Pre–Tax Profits Tutor Perini disclosed in its Pre–Tax Profit Reports, having not been disputed, are binding upon ***both*** IH Rep and Tutor Perini and the required Earn–Out Payments must be calculated and paid from these amounts. To accept Tutor Perini's construction of Section 2.14 would be to render the language “shall be binding” superfluous—a result, under our law, that must be “avoided.”

Tutor Perini's argument that it does not owe Earn–Out Payments whenever it can demonstrate that it calculated Pre–Tax Profits for an Earn–Out Year based on financial statements that were not GAAP compliant fails at the threshold. Nothing in the Definitions Section reasonably can be read to negate or qualify Section 2.14's mandate that if IH Rep does not object within thirty days of receiving a Pre– Tax Profit Report, the report and the Pre–Tax Profit stated therein are binding on all parties. Instead, the Definitions Section simply defines how *Tutor Perini* must calculate Pre–Tax Profit—it must do so “in accordance with past practices and based upon financial statements (prepared in accordance with GAAP consistently applied) of the Company.” Section 2.14 makes no reference to this Definition, nor do the express terms of the provision even hint that the parties intended to relieve Tutor Perini of its earn-out obligations in the event Tutor Perini is later able to demonstrate that *it failed* properly to calculate Pre–Tax Profit by relying on inaccurate financial statements that *it prepared*. What Section 2.14 *does* make clear is that once Tutor Perini prepares the Pre–Tax Profit

> Report, and provides it to IH Rep, if IH Rep does not timely object, the report and the Pre–Tax Profit disclosed therein are "binding."[28]

The court rejected the buyer's argument that the role of an interested individual in preparing the financial statements violated the implied contractual covenant of good faith and fair dealing because there were no contractual gaps to be filled by the covenant:

> "Faced with Section 2.14's unambiguous language, Tutor Perini argues that there is a gap in the Merger Agreement with respect to the accuracy of the Pre–Tax Profits as related to Earn–Out Payments. Accordingly, it urges the Court to imply a term that would require Tutor Perini to make Earn–Out Payments based only on accurate Pre–Tax Profit calculations. This, Tutor Perini argues, would surely have been the agreement of the parties had they considered the issue of accurate Pre–Tax Profit numbers, and any contrary interpretation would be "unreasonable and absurd."
>
> To be sure, "the implied covenant of good faith and fair dealing attaches to every contract by operation of law and requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." The covenant exists, however, solely to fulfill the reasonable expectations of the parties; it cannot be employed to circumvent the parties' bargain. Therefore, in order for the implied covenant to apply, the contract's language must not address the obligation asserted and the obligation to be implied must not contradict "the purposes reflected in the express language of the contract." Our courts are reluctant to imply terms based on the covenant of good faith and fair dealing "when a contract easily could have been drafted to expressly provide for [the missing terms]."
>
> There are no gaps to fill here. Section 2.14 clearly reflects the parties' intent to impose a definitive timeline within which the accuracy of the Pre–Tax Profit, as presented in the Pre–Tax Profit Report, could be challenged. Such challenges are to be brought before a neutral accountant for summary resolution. Had the parties intended to allow Tutor Perini to withhold Earn–Out Payments whenever it believed it had calculated Pre–Tax Profits based on inaccurate information, they easily could (and surely would) have provided such language as part of the bespoke process they agreed to in Section 2.14. They did not. Therefore, I will not imply a term

[28] *Id*. at *6-7.

that is inconsistent with the intent of the parties as evidenced by the express terms of the agreement."[29]

Thus, the court determined the amount due for years three, four and five to total $20 million and ordered Tutor to make the earnout payment to the GreenStar Rep.[30] Importantly, Vice Chancellor Slights highlighted that the two parties could have, but did not, negotiate for a procedure in the acquisition agreement which would have allowed Tutor to withhold an earnout payment on the condition that it doubted the accuracy of the financial metrics used to calculate the Pre-Tax Profits for the report.[31]

The *Tutor Perini* case highlights that Delaware courts will look at the structure and terms of the earnout as it is written in the purchase and sale agreement. For that reason, it is important to consider the following terms when contemplating or drafting an earnout for a purchase and sale agreement.

a. **Length of Earnout Period and Information Rights**

One of the first items to be discussed and decided when negotiating and drafting an earnout provision is the length of the earnout period. Determining the length of the earnout period typically involves the buyer and seller weighing the different factors and determining what length of time is appropriate for obtaining a reliable projection of the future earning potential of the business. The buyer typically desires a longer earnout period as the longer the earnout period lasts, the more the earnout will provide the buyer with a reliable look into how the acquired business actually performs. However, a longer earnout period places a longer period of restrictions on the business and a longer timetable for both parties to pay and receive the total amount of compensation for the purchase and sale of the business.

In *Tutor Perini*, the earnout period was 5 years. The first two years after the sale were profitable and the acquired business performed well and had a Pre-Tax Profits of $75.4 million and $65.5 million respectively.[32] However, year three saw the Pre-Tax Profits of the acquired business diminish to $31.6 million, less than half of the year two Pre-Tax Profits.[33] This dramatic change in the Pre-Tax Profits is what led to Tutor's mistrust of the acquired business' financial metrics which led to Tutor withholding the earnout payments for year's three, four and five.

The five-year earnout period in *Tutor Perini* highlights the interplay between the longer earnout period and the more reliable financial information provided to the buyer. The *Tutor Perini* case also demonstrates that the longer the earnout period lasts, the longer the seller will be required to wait in order to receive its full and complete compensation for the sold business.

[29] *Id*. at*7-8;

[30] See *Id*.

[31] *Id*.

[32] *Id*. at *2-3

[33] *Id*. at *2-4

Including the subsequent litigation, the seller waited over 6 years from the execution of the Purchase Agreement to receive all its the financial payments from Tutor.

Both parties will likely want information rights regarding the financial numbers used in the calculation of the earnout. The seller will also desire a right to review and approve of the specific reports which will determine the calculation of the earnout amount during the earnout period. If the buyer is obtaining information from "carryover" employees of the acquired business then buyer will desire a right to verify and object or double-check financial metrics if the buyer feels the information provided is fraudulent or inaccurate. The buyer's right to verify the financial metrics is even more important if the carryover employees are also receiving a significant portion of the earnout payments. For instance, in *Tutor Perini*, Tutor was required to provide the Pre-Tax Profits Report to the GreenStar Rep under the following terms:

> "Within ninety (90) days after each twelve-month period in the Earn–Out Term, [Tutor Perini] shall in good faith prepare (or cause to be prepared) and deliver to the Interest Holder Representative a report ... The Pre–Tax Profit Report and the Pre–Tax Profit for the twelvemonth period reflected thereon, shall be binding upon the [GreenStar Rep], Stockholders and [Tutor Perini] upon the approval of such Pre–Tax Profit Report by the [GreenStar Rep] or the failure of the [GreenStar Rep] to object in writing within thirty (30) days after receipt thereof by the [GreenStar Rep]. If the [GreenStar Rep] does not agree with the Pre–Tax Profit Report and the calculation of the Pre–Tax Profit stated thereon, and [Tutor Perini] and the [GreenStar Rep] cannot mutually agree on the same, then within forty-five (45) days following receipt by the [GreenStar Rep] of the Pre–Tax Profit Report, [Tutor Perini] and the [GreenStar Rep] shall engage the Neutral Accountant to resolve such dispute."[34]

Under the terms of the *Tutor Perini* information rights provision, the GreenStar Rep was not only afforded the opportunity to inspect and object to the Pre-Tax Profits Report, but also afforded the remedy of engaging a neutral accountant to resolve a dispute between the parties as to the values set forth in the Pre-Tax Report. In *Tutor Perini*, the one of the largest recipients of the earnout amount paid to the GreenStar Rep was a key person in determining the financials which largely affected the Pre-Tax Profits Report.[35] Importantly, if the GreenStar Rep did not object within the specified 30-day timeframe after receipt of the Pre-Tax Report, then the GreenStar Rep was deemed to have waived their right to object to the Pre-Tax Report. This language provided the GreenStar Rep with an opportunity to inspect and object to the report, but it did not allow them to stall or take an indefinite amount of time to review the report. It also estopped the buyer from later complaining that the financials involved an interested party.

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[34] *Id*. at *3

[35] *Id*. at *2-4

b. **Earnout Cap, Offset Rights and Carrybacks**

After the buyer and seller agree on the length of the earnout, the parties can begin negotiating other earnout provisions, such as whether the earnout contains a floor or cap amount or if the earnout is subject to offset rights or carrybacks.

An earnout cap limits the total amount of earnout compensation that the buyer could be obligated to pay. A cap can limit the earnout amount only for a particular year with the cap resetting every year, or the parties can negotiate a cap of the total amount of the earnout consideration paid out during the complete earnout period. Conversely, a floor sets the baseline amounts of earnout compensation that the buyer will pay the seller regardless of the performance of the acquired business. A floor can be negotiated to apply to each individual year of the earnout or the total amount of earnout consideration paid during the complete earnout period.

If the parties negotiate for a cap or floor on the total amount of earnout consideration, the seller typically will desire an offset right, which allows the seller to use the earnout payments as an offset against any future indemnification claims that the buyer might bring. The seller will also desire some sort of carryback mechanism where the earnout can be adjusted with respect to payments made and missed payments from previous installments based on subsequent performance. Earnout provisions which provide for offset rights or carrybacks could present issues similar to *Tutor Perini*, where the $8 million cap was achieved for each of the first two years and there was a carryback amount of $9.2 million carried forward into year three.[36] Then, when the Pre-Tax Profits of the acquired business diminished, the $9.2 million carryback required Tutor to pay an earnout payment of $8 million for year three; however, since the Pre-Tax Profits were less than half of the Pre-Tax Profits of the previous year, Tutor likely could not have paid the earnout amount out of the acquired business' profits and would have to make the payment out of profits of a different or unrelated business.[37] This is an example of how excess earnout amounts over the annual cap can lead to a significant payment required under the earnout even when the acquired business is declining or struggling. Thus, if the seller desires a carryback mechanism for the earnout consideration, it is in the buyer's best interest to negotiate for offset rights, where it can offset the earnout amounts owed against any claim for which the seller would be required to indemnify the buyer. However, sellers must be aware that provisions such as offset rights against earnout amounts incentivize the buyer to make additional claims for indemnification under the Purchase Agreement as such claims would offset any future earnout payments which it might be required to pay to the seller.

c. **Governing Jurisdiction and the Duty of Good Faith**

Choosing the governing law for the purchase agreement and the earnout is an important step in negotiating the earnout as the state's interpretation of the implied covenant of good faith and fair dealing can be outcome determinative. In Delaware, the contractual duty of good faith and fair dealing has been summarized as follows:

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[36] *Id*. at *2-3

[37] *Id*. at *2-5

> The covenant of good faith and fair dealing is implied in every contract, and 'requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.' However, the implied covenant of good faith and fair dealing, as the Plaintiffs recognize, serves a gap-filling function by creating obligations only where the parties to the contract did not anticipate some contingency, and had they thought of it, the parties would have agreed at the time of contracting to create that obligation. Thus, 'the implied covenant is not a license to rewrite contractual language just because the plaintiff failed to negotiate for protections that, in hindsight, would have made the contract a better deal. Rather, a party may only invoke the protections of the covenant when it is clear from the underlying contract that the contracting parties would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter.'"[38]

The Delaware courts have examined the interplay between the duty of good faith and fair dealing and an earnout provision and held that the duty of good faith and fair dealing does not obligate the buyer to act in a manner which maximizes the seller's potential earnout.[39] In the *American Capital* decision, the Delaware Chancery Court examined whether the implied covenant of good faith and fair dealing required LPL Holdings to make technological changes to the acquired business in order to maximize the earnout it would owe to the seller, American Capital.[40] The Stock Purchase Agreement between the two parties included a complicated earnout provision which stated the LPL Holdings would pay American Capital an earnout amount of with a floor of $215,000 and a cap of $15 million.[41] American Capital argued that the parties engaged in several meetings prior to signing the Purchase Agreement which focused on how LPL Holdings could maximize the synergies via LPL Holdings' acquisition of the acquired business.[42] American Capital expected the synergies present between the acquired company and LPL Holdings to lead to a significant earnout; however, after closing it became apparent that LPL Financial's computer systems could not be easily adapted in a way which would be compatible with the acquired business proposed business model.[43] In examining whether LPL Holdings was obligated to make the necessary technological changes to its computer system in order to maximize American Capital's earnout, Vice Chancellor Glasscock wrote:

> "Here, the Defendants correctly point out that, in connection with their fraud claims, the Plaintiffs make multiple assertions that the parties anticipated and discussed, prior to signing the SPA and employment agreements, that it would be helpful to make

[38] *American Capital Acquisition Partners LLC v. LPL Holdings*, WL 354496, at *5 (Del. Ch. 2014).

[39] *Id*.

[40] *Id.* at *2-3.

[41] *Id*.

[42] *Id*. at *2-4.

[43] *Id*. at *3-4.

> technological adaptations in order to integrate Concord's and LPL Financial's services. At that time, the Plaintiffs chose not to bargain for specific language requiring LPL to make those adaptations, and they cannot now claim that the parties did not anticipate such language would be necessary.
>
> [. . .]
>
> The Plaintiffs anticipated, but failed to bargain for, a requirement that the Defendants adapt their software and datahandling capabilities for Concord–LPL's benefit. Because the implied covenant of good faith and fair dealing serves only a gap-filling function, and the Plaintiffs do not allege that the parties failed to anticipate the need for technological adaptations, this portion of the implied covenant count must be dismissed."[44]

Additionally, American Capital argued that LPL Holdings had breached the implied covenant of good faith and fair dealing by taking affirmative steps to impede the acquired business' ability to generate revenue.[45] Specifically, American Capital claimed that LPL Holdings "pivoted" sales from the acquired business to one of the buyer's preexisting business in effort to avoid making a significant escrow payment under the terms of the Purchase Agreement.[46] Vice Chancellor Glasscock wrote that redirecting sales from the acquired business to a preexisting business violates the implied covenant of good faith and fair dealing, stating:

> "I find that the Plaintiffs' allegations here are sufficiently specific to support an inference that the Defendants have breached the implied covenant of good faith and fair dealing. Taken together, the contingent purchase price provision in the SPA, the compensation targets in the employment agreements, and Section 2.06(c), which provides for the calculation of revenue in order to determine the payments to which the Plaintiffs are entitled under the two former agreements, demonstrate that, had the parties contemplated that the Defendants might affirmatively act to gut Concord– LPL to minimize payments under the SPA and employment agreements, the parties would have contracted to prevent LPL from shifting revenue from Concord–LPL to Fortigent.
>
> Additionally, I find that the Plaintiffs have sufficiently pled damages as a result of the Defendants' breach. The Plaintiffs plead that, by agreeing to the contingent purchase price provision in the SPA, they forewent offers from other potential buyers for larger upfront payments. Further, the Plaintiffs plead that both parties anticipated that the transaction would generate large synergies, and it is at least

[44] *Id*. at *5-6.

[45] *Id*. at 6.

[46] *Id*.

> a reasonably conceivable inference based on that assertion that, had the Defendants not interfered with Concord's ability to generate revenue, it would have reached its revenue targets sufficient to trigger payment under the contingent purchase price provision of the SPA and employment agreements. The Defendants' Motion with respect to this portion of the implied covenant claim is therefore denied."[47]

If Delaware is chosen for the governing law of a purchase agreement with an earnout provision like the one in *American Capital,* the implied duty of good faith and fair dealing would obligate the buyer to not purposefully divert the acquired business' sales in order to lower the earnout payments, but the buyer would not be required to make the business plan changes necessary in order to maximize the seller's potential earnout.

Texas has not extended the implied duty of good faith and fair dealing to obligate the buyer to achieve the seller's earnout absent specific provisions creating such obligation.[48] In contrast, courts in California and Massachusetts have interpreted of the implied covenant of good faith and fair dealing to obligate the buyer to seek to maximize the seller's earnout.[49] Thus, the choice of jurisdiction for purposes of the purchase agreement may have dramatic results on the buyer's implied duty of good faith and fair dealing in regards to the buyer's obligation to help the seller realize the maximum value of the earnout under the Purchase Agreement.

With this general uncertainty as to the exact requirements and limits of the implied covenant of good faith, parties have begun inserting contractual obligations of "good faith", "best efforts" and "commercially reasonable efforts" as the standard according to which the buyer must work to help the seller achieve its earnout. *Fortis Advisors LLC v. Dialog Semiconductor PLC*[50] compared the interplay between the implied covenant of good faith and an express covenant stated in the merger agreement.[51] In 2013, Dialog completed their merger with iWatt and Fortis was appointed as the representative of the former equityholders of iWatt.[52] Dialog agreed to acquire iWatt for

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[47] *Id*. at *7.

[48] *Helitrans Company v. Rotorcraft Leasing Co., LLC*, 2015 WL 593310 (Tex. App. Houston 1st Dist. 2015) (Appellant's breach of a contract action provided all but one benchmark that needed to be reached to trigger an additional payment. The trial court properly found that this provision neither specified the exact amount of additional payment, nor provided a method of calculation for such payment in the event that the payment was triggered, and no terms or formulas were provided else in the amendments or Asset Purchase Agreement. The Appeals Court held that in order to find that the provision provided a prorated earnout would require the trial court to rewrite the provision, which the Court ruled it was not permitted to do).

[49] The covenant of good faith and fair dealing imposes an affirmative duty on each party to do everything that a reasonable interpretation of the contract presupposes he will do to accomplish the purpose of the contract, even if those acts are not expressly required by the contract itself. *See Eastwood Ins. Services, Inc. v. Titan Auto Ins. of New Mexico, Inc.*, 469 Fed. Appx. 596 (9th Cir. 2012) (applying California law) (Material issues of fact existed as to whether the defendant's efforts to maximize the performance of the plaintiff's assets were commercially reasonable, as required by the earnout clause in the purchase agreement). *See generally Sonoran Scanners v. PerkinElmer*, 585 F.3d 535 (1st Cir. 2012) (PerkinElmer breached an implied covenant in an asset purchase agreement when it failed to develop and promote a plate-printing technology product).

[50] 2015 WL 4101371 (Del. Ch. 2015).

[51] *See Id*.

[52] *Id*. at *1.

$310 million plus earnout payments of up to $35 million depending on Dialog's Power Conversion Business Group (after the merger was completed, iWatt operated as a separate, stand-alone business unit of Dialog's Power Conversion Business Group).[53] As part of the Merger Agreement, Dialog was required to use its commercially reasonable best efforts to achieve and pay the earn-out payments in full:

> "From the Closing Date through the end of the Second Earnout Period, [Dialog] ***shall, and shall cause its Affiliates ... to, use commercially reasonable best efforts,*** in the context of successfully managing the business of the Surviving Corporation, ***to achieve and pay the Earn–Out Payments in full*** (it being understood and agreed that one of the primary objectives of managing the business of the Surviving Corporation shall be to achieve and pay the Earn–Out Payments in full, provided that, subject in all respects to its obligations under this Agreement, [Dialog] is entitled to make changes to the business in its reasonable commercial judgment in order to achieve the objectives in managing the business of the Surviving Corporation), including allocating appropriate and sufficient resources (including sufficient capital expenditure, working capital and human resources) to the Surviving Corporation and its Subsidiaries to enable the achievement and payment of the Earn–Out Payments in full.
>
> [. . .]
>
> Without limiting the generality of the foregoing, (i) [Dialog] shall, and shall cause its Affiliates ... to (A) operate the business of the Surviving Corporation and its Subsidiaries as a separate, stand-alone business unit (understanding that [Dialog] may elect to integrate sales, service, supply chain and administrative functions with those of [Dialog]), (B) maintain a separate research and development organization within such business unit with engineering headcount at a level not materially below that currently maintained by the Company and (C) price the products of the Surviving Corporation on a standalone basis and without any reduction related to the pricing of products by Parent's other product lines and (ii) [Dialog] shall not, and shall not authorize or permit its Affiliates ... to, (A) take any action with the intent of avoiding or reducing the payment of any Earn–Out Payment, (B) divert to another business of [Dialog] any business opportunity in a manner that could reasonably be expected to or does diminish or minimize the Earn– Out Payments, (C) take any action for the purpose of shifting Revenue outside of the Earn–Out Periods ... or reducing Revenue...."[54]

[53] *Id*. at *1-2.

[54] *Id*. at *2.

Six months after the merger, Dialog notified Fortis that the Power Conversion Business Group reported revenues of $35.355 million during the first earnout period, which was considerably lower than the $51.3 million revenue threshold required to trigger an earnout payment under the Merger Agreement.[55] In response Fortis responded that the Power Conversion Business Group had three key shortfalls, which all could have been avoided "if Dialog had used its commercially reasonable best efforts … to achieve and pay" the earnout payments.[56] In reviewing Fortis' claims, Chancellor Bouchard held that the implied covenant did not apply in this case, stating:

> "Under Delaware law, the implied covenant of good faith and fair dealing attaches to every contract by operation of law and "requires 'a party in a contractual relationship to refrain from arbitrary or conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain '[T]he implied covenant only applies where a contract lacks specific language governing an issue and the obligation the court is asked to imply advances, and does not contradict, the purposes reflected in the express language of the contract." "The Court must focus on 'what the parties likely would have done if they had considered the issues involved.' It must be 'clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of ... had they thought to negotiate with respect to that matter.' " Where the contract speaks directly regarding the issue in dispute, "[e]xisting contract terms control ... such that implied good faith cannot be used to circumvent the parties' bargain, or to create a 'free-floating duty unattached to the underlying legal documents.'" "To state a claim for breach of the implied covenant, a litigant must allege a specific obligation implied in the contract, a breach of that obligation, and resulting damages." [57]

Instead of the implied duty, Chancellor Bouchard focus his analysis on the "best efforts" language of the Merger Agreement, writing:

> "Fortis reasonably expected that Dialog would use its best efforts to achieve and pay the earnout payments in full during both the First and Second Earn– Out Periods," but Dialog did not. The Merger Agreement, however, expressly imposed on Dialog the obligation to use "commercially reasonable best efforts to ... achieve and pay the Earn–Out Payments in full." Thus, the Merger Agreement sets a contractual standard by which to evaluate if Dialog's failure to achieve and pay the earn-out payments in its operation of the Power

[55] *Id*.

[56] *Id*.

[57] *Id*. at *3.

> Conversion Business Group was improper. There is no gap in the Merger Agreement to fill in this regard."[58]

Thus, if the seller alleges that the buyer has breached either the purchase agreement or the implied covenant of good faith and fair dealing by failing to use "best efforts" or "commercially reasonable best efforts" to maximize the seller's earnout, and the purchase agreement provides an express covenant of efforts required to be used, then the Courts will review the express standard set forth in the contract, and not the implied standard, as the purchase agreement expressly provides the contractually agreed-upon best efforts standard which should be applied. Therefore, if the parties decide to include a contractual standard in the purchase agreement, the seller and buyer will likely desire a different level of "effort" to be applied.

In an M&A Transaction, the different level of efforts are generally understood as follows:

> "[*Efforts*] clauses are commonly used to qualify the level of effort required in order to satisfy an applicable covenant or obligation. An absolute duty to perform covenants or similar obligations relating to future actions will often be inappropriate or otherwise not acceptable to one or more parties to the agreement, as, for instance, when a party's ability to perform depends upon events or third-party acts beyond that party's control. In such circumstances, parties typically insert "efforts" provisions.
>
> There is a general sense of a hierarchy of various types of efforts *clauses* that may be employed. Although formulations may vary, if the agreement does not contain a definition of the applicable standard, some practitioners ascribe the following meanings to these commonly selected standards:
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> - *Best efforts:* the highest standard, requiring a party to do essentially everything in its power to fulfill its obligation (for example, by expending significant amounts or management time to obtain consents).
> - *Reasonable best efforts:* somewhat lesser standard, but still may require substantial efforts from a party.
> - *Reasonable efforts:* still weaker standard, not requiring any action beyond what is typical under the circumstances.
> - *Commercially reasonable efforts:* not requiring a party to take any action that would be commercially detrimental, including the expenditure of material unanticipated amounts or management time.

[58] *Id*. at *5.

- *Good faith efforts:* the lowest standard, which requires honesty in fact and the observance of reasonable commercial standards of fair dealing."[59]

If the parties decide to include an express definition as to the level of efforts the buyer must use when ensuring that it will achieve the seller's earnout, deciding among the above-mentioned terms will likely be among the major discussion items. The seller will undoubtedly desire a covenant that the buyer will use its best efforts to achieve the milestones necessary in order to achieve the earnout; however a best efforts covenant would require the buyer to do everything, and potentially undertake actions which are not in the acquired company's long-term benefit, to achieve the seller's earnout. Therefore, the buyer would likely want to promise no more than its good faith efforts in achieving the seller's earnout. However, as examined in *Fortis Advisors*, if the parties agree to an express covenant regarding their efforts, the implied covenant of good faith will not be read into the agreement. Thus, if the seller were to agree to the buyer's good faith efforts, it would require only honest in fact efforts in observance with a reasonable commercial standard and the seller would not benefit from the implied covenant.

In addition, the buyer will likely desire to specifically disclaim any obligation relating to the acquired business and its achievements of the performance targets except those specifically set forth in the earnout metrics or in the express covenant and obligations of the buyer, and the parties will likely negotiate an anti-reliance statement which states that the purchase agreement is the sole agreement. This leaves either the implied covenant, if the agreement is silent as to the buyer's duty to maximize the seller's earnout, or the level of efforts described in the express covenant as the standard that the buyer will have to undertake in attempt to maximize the seller's earnout.

d. **Tailored Remedies, Acceleration Rights, Putback Rights and Buyout Rights**

As the Seller will not receive full consideration for the business acquired by the buyer until the end of the earnout period, the Seller will be particularly conscious of any specific remedies which it can pursue for breaches of the purchase agreement, a withholding of the earnout payment, or a change of control of the acquired business before the earnout period has terminated. These tailored remedies provisions could include specific remedies for breaches of the purchase agreement, such as a liquidated damages provision, specific and enumerated adjustments to the calculation of the earnout formula, or acceleration or additional payment of a specified amount of the earnout consideration.

For a lengthy earnout period, where the seller would not receive the full consideration until the complement of the earnout period, the seller may be worried that a potential change in control of the acquired company would bring a substantial risk on the business' ability to fulfill the requirements which would result in the full earnout payment being owed to the seller. In such scenarios, the seller may seek to include an acceleration right to the earnout consideration, which permits the seller to accelerate the payment of the earnout after certain events, such as the sale of the business, or upon the accomplishment of various financial events which indicate the seller will be owed the full earnout amount at the end of the earnout period. This benefits the seller as it allows it to unilaterally demand the advancement of the earnout funds if the buyer agrees to

[59] American Bar Association, Business Law Section, *supra* note 4.

sell the business an unrelated third-party who may or may not run the business in a manner which would meet the earnout requirements, or the accomplishment of various financial events make it clear to the seller that it will be entitled to the full earnout amount at the conclusion of the earnout period.

Similarly, the buyer may desire a right to terminate the seller's right to an earnout payment upon the buyer's notice and payment of a certain amount of money at specific points during the earnout period. This essentially gives the buyer an option to buy its way out of an earnout dispute at a pre-arranged price, and is a useful mechanism to avoid a legal dispute over earnout. Alternatively, an earnout could be structured with a "putback" right, where if a material earnout dispute arises, one or both of the parties can elect to have the acquired business sold back to the seller at a specified price.[60] Buyout rights or putback rights both serve the same purpose of allowing parties to make pre-arranged and agreed-upon transaction in order to terminate a potential earnout dispute.

e. **<u>Earnout Calculation and Fees</u>**

Earnouts can be structured as a fixed-fee payment to be made from the buyer to the seller on the completion of all of the performance targets or conditions, or earnouts can be structured as a graduated formula payment based on partial satisfaction of performance targets (similar to the Pre-Tax Profits Report and calculation in *Tutor*). However, it is important to consider whether a graduated formula would incentivize the buyer to miss the achievement of one or more of the performance targets or incentivize the seller to stretch to reach the achievement only to have that stretch be in the future detriment of the business. Either way, courts in various jurisdictions have made clear that the dispute of a discrepancy in the calculation of the earnout, whether fixed-fee or a graduated formula, will be subject only to the agreed-upon terms of the earnout in the purchase agreement.[61]

For example, in August of 2010, Exelon Generation Acquisitions agreed to acquired John Deere Renewables, LLC, a subsidiary of Deere & Company which held its wind assets, for the base purchase price of $860 million.[62] In the purchase agreement, Exelon agreed to make earn-out payments to Deere if it reached certain milestones in the development of three proposed wind farm projects which were underway at the time of the acquisition.[63] The project at issue is the Blissfield Wind Project, which was defined in the Purchase Agreement as "the wind project under development in Lenawee County, Michigan, by Blissfield Wind Energy, LLC with a nameplate capacity of 81 megawatts.[64] Included in the acquisition of the wind assets was a "Power Purchase Agreement", which is a binding commitment Deere had secured from a local utility where the utility would purchase energy from the wind farm once it became operational.[65] Exelon was unable to acquire the land for a wind farm in Lenawee County, Michigan due to civic

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[60] *See* Weinstein, Schwenkel and Shaw, *supra* note 8.

[61] *Exelon Generation Acquisitions, LLC v. Deere & Company*, 176 A.3d 1262 (Del. 2017); *See Tutor*, WL 5035567

[62] *Exelon* 176 A.3d at 1263-74.

[63] *Id*.

[64] *Id*. at 1264.

[65] *Id*. at 1264-68.

and political issues which were beyond their control.[66] However, Exelon acquired a different wind from in Gratiot County, Michigan (which is about 100 miles away from the Lenawee County proposed wind farm) and Exelon was able to convince the local utility to transfers the Power Purchase Agreement to from the Lenawee County site to the Gratiot wind farm.[67]

Deere brought a claim to recover the earnout payment and argued that Exelon had moved the Lenawee Country wind farm to Gratiot County and that the earnout payment obligation had traveled from the proposed wind farm in Lenawee County the completed wind farm in Gratiot County.[68] The Delaware Supreme Court ruled in favor of Exelon, holding:

> "We begin with the Purchase Agreement's plain language. Exelon's obligation to pay Deere an earn-out for the Blissfield Wind Project was contingent upon "the Blissfield Wind Project achiev[ing] Completion of Development and Commencement of Construction." The "Blissfield Wind Project" is defined by the Agreement to mean "the wind project under development in Lenawee County, Michigan, by Blissfield Wind Energy, LLC, with a nameplate capacity of 81 megawatts." Together, then, payment of the earn-out was contingent upon "the wind project under development in Lenawee County, Michigan," achieving "Completion of Development and Commencement of Construction." On its face that presents a problem for Deere, because there is no dispute that the wind project in Lenawee County neither completed development nor commenced construction—civic opposition saw to that. But Deere believes the key lies in the definition of the term "Completion of Development and Commencement of Construction." Under the Agreement, a "Completion of Development and Commencement of Construction" could be triggered in one of two ways. The first is the achievement of five development milestones that are spelled out in the Agreement. The second is the reaching of a "Commercial Operation Date."
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> [. . .]
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> But Deere's argument glosses over textual difficulties that arise when the interlocking terms in the earn-out provision are read together. As explained, the earn-out payment was contingent upon "the Blissfield Wind Project achiev[ing] Completion of Development and Commencement of Construction." Fully unpacked, that means that payment was contingent upon "the wind project under development in Lenawee County, Michigan achiev[ing]" either the five milestones specified in the Purchase Agreement or the milestones "set forth in the Michigan PPA related

[66] *Id*.

[67] *Id*.

[68] *Id*.

> to . . . [‘the wind project under development in Lenawee, County, Michigan’].” Although it is true that the milestones set forth in the PPA were achieved, at the time they were achieved the PPA was no longer “related to ... [‘the wind project under development in Lenawee County, Michigan’]”—it had been amended to relate to the Beebe Wind Farm. And even if the PPA, post-amendment, still “related to” the Lenawee County project by virtue of the fact that it was the same agreement that, at one time, had related to that development, the earnout was due only if “the wind project under development in Lenawee County, Michigan, achiev[ed]” the milestones in the PPA. But it was not that wind project that achieved the milestones—it was the Beebe Wind Farm, in Gratiot County.”[69]

Given the narrow definition of the earnout in the Purchase Agreement in *Exelon*, the Delaware Supreme Court ruled that the criteria for the earnout had not been achieved. Given the court’s reasoning, Deere might have prevailed on their claim if the earnout had been based on the specific wind farm located in Lenawee County. It is important to focus on the specific criteria upon which the payment will be derived, as such criteria will be interpreted strictly by the applicable court.

4. ADDITIONAL PRACTICE POINTS

a. Avoid “Aspirational” Earnout standards

“[S]ince value [of the acquired business] is frequently debatable and the causes of underperformance [of an earnout] equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome.”[70] While courts routinely rule on earnout disputes, which are typically focused on either a dispute over the post-closing business operations[71] or a dispute over post-closing accounting methodologies[72], the courts have shown a reluctance to

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[69] *Id*. at 1267-69.

[70] *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del. Ch. 2009).

[71] *See generally Lazard Technologies Partners LLC v. QinetiQ North America Operations LLC*, WL 1880153 (Del. 2015) (Alleged failure to pursue opportunities which could have increased the earnout); *Winshall v. Viacom Int’l Inc.*, 76 A.3d 808 (Del. 2013) (Viacom alleged that Harmonix had an implied duty to negotiate a more favorable distribution agreement which would have resulted in a larger earnout. The Court ruled there was no breach of the implied duty of good faith as Harmonix did not intentionally push revenue out of the earnout period.); *American Capital Acquisition Partners*, WL 354496 (Del. Ch. 2014) (Alleged failure make necessary changes in order to maximize earnout); *Lazard Technologies Partners LLC v. QinetiQ North America Operations LLC*, WL 1880153 (Del. 2015) (Alleged failure to pursue opportunities which could have increased the earnout).

[72] *See generally Comet System, Inc. Shareholders’ Agent v. MIVA, Inc.*, 980 A.2d 1024 (Del. Ch. 2008) (Earnout does not account for treatment of certain expenses and revenues); *Partners v. Genesee & Wyoming, Inc.*, WL 2000765 (Del. Ch. 2005) (Genesee’s calculation of EBITDA for purposes of the agreements was improper because Genesee made certain adjustments not permitted by the purchase agreement).

adjudicate claims which involve the parties placing "aspirational" standards in the earnout agreement and then seeking to adjudicate claims based on such aspirational standards.[73]

In the *LaPoint* case, two companies, Bridge Medical and AmeriSourceBergen Corporation ("***ABC***"), agreed to merge with each other, where ABC agreed to pay the former Bridge shareholders an initial payment of $27 million and additional earnout payments, which had no floor and a cap of $55 million and were contingent upon certain EBITA targets being meet in 2003 and 2004.[74] Both parties expected to benefit from the ABC acquisition by allowing ABC to combine a lower-margin drug distribution with its higher value-added services throughout the hospital supply chain industry.[75] In addition, the Bridge shareholders anticipated an increased market presence due to their merger with ABC and ABC's exclusive and active promotional assistance.[76] To address the risk that ABC might try to avoid its obligations under the Merger Agreement and the earnout provision, the following language was added to the merger agreement:

> "[ABC] agrees to (and shall cause each of its subsidiaries to) *exclusively and actively* promote [Bridge's] current line of products and services for point of care medication safety. [ABC] shall not (and shall cause each of its subsidiaries to not) promote, market or acquire any products, services or companies that compete either directly or indirectly with [Bridge's] current line of products and services.
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> [. . .]
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> [ABC] will act in good faith during the Earnout Period and will not undertake any actions during the Earnout Period *any* purpose of which is to impede the ability of the [Bridge] Stockholders to earn the Earnout Payments.[77]

In his review of the above sections of the merger agreement, Chancellor Chandler held that these standards were too "aspirational" and nebulous to be enforced, stating:

> "Unfortunately, much of the merger agreement consists of the sort of aspirational statements mentioned above, and these gossamer definitions have proven too fragile to prevent the parties from devolving into the present dispute. Although the terms of the agreement undoubtedly required ABC to "actively" promote Bridge products, defendant insists that efforts made over the course of the ABC/Bridge relationship were sufficient to satisfy this nebulous requirement. Plaintiffs object that the assistance provided could not reasonably be said to be enough. The parties further dispute whether ABC's obligation not to undertake action "any purpose of which is to impede the ability of the [Bridge] Stockholders to earn the

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[73] *See generally LaPoint v. AmeriSourceBergen Corp.*, WL 2565709 (Del. Ch. 2007).

[74] *Id*. at *1-2.

[75] *Id*.

[76] *Id.*

[77] *Id*.

> Earnout Payments" required ABC to proceed with additional transactions disadvantageous to ABC, or whether ABC was entitled to enforce an unwritten press release policy that restricted Bridge's ability to access the business wire.
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> [. . .]
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> Plaintiffs allege that ABC's actions constituted multiple breaches of the merger agreement, and that but for these breaches, plaintiffs would have been entitled to a full earnout payment in 2003 and 2004. Defendant denies that a breach has occurred, and further maintains that any claim for damages is, at best, speculative. Even had ABC used every effort to support Bridge, and defendant insists that it did just this, Bridge's history of missed sales targets and non-existent profitability suggests that Bridge would never have met its EBITA targets.
>
> [. . .]
>
> In short, plaintiffs fail to demonstrate that ABC's general failure to promote Bridge during the earnout period led to damages that can be fixed to a reasonable degree of certainty.[78]

Instead of enforcing these "aspirational standards", the courts have repeatedly enforced the "plain language" of the earnout as written in the purchase agreement or merger agreement.[79] In doing so, the courts are not going to aid a sophisticated party who could have, but failed to, negotiate more specific contractual provisions which dictate the terms of the earnout provision.[80] Thus, when drafting an earnout provision, aspirational standards should be avoided and the drafter should instead focus on the plain language of the earnout in the Purchase Agreement.

b. **<u>Draft the Earnout with Contextualized Provisions to the Business</u>**

Best practices in drafting the earnout provision include attention to three items: 1) who will prepare the financial calculations and documents from which the earnout amount will be derived; 2) what approval rights and dispute resolution mechanisms does the other party have in regards to the financial calculations; and 3) the earnout provision itself should include general statements of the parties' intent in addition to hypothetical examples of how the earnout will be calculated for illustrative purposes.

Typically, the buyer, who takes control of the acquired business post-closing, is the party which will draft the financial reports from which the earnout is to be computed; however, when the seller stays on to manage the day-to-day operations of the acquired business, it may be

[78] *Id* at *2-10.

[79] *See Tutor Perini*, WL 5035567 (Tutor Perini did not follow the mechanisms set forth in the Purchase Agreement to contest the validity of the financial reports; *See generally LaPoint*, WL 2565709 (The Court stated it could not enforce the aspirational standards of the Purchase Agreement).

[80] *See generally Id*.

appropriate for the seller to draft the financial documents. The party who reviews the report is going to want some type of covenant or guarantee that the financial numbers have not be altered in any way which increases or diminishes the earnout amount. While such affirmative covenants may be negotiated in the purchase agreement, the parties can also agree to only use audited accounting methods that are in accordance with GAAP as the basis for the financial reports.

When the party who receives the financial reports is going to require some kind of approval or objection right, the agreement typically specifies how long the recipient will have to approve or contest the report. For instance, in *Tutor Perini* the GreenStar Rep had 30 days after receipt of the Pre-Tax Profits Report to object to the Report; if the GreenStar Rep did not object, he was deemed to have waived his ability to object and the report was deemed approved. If the reviewing party does object, the purchase agreement needs to provide specific language which discusses how the objection will be resolved. For instance, in *Tutor Perini* the GreenStar Rep never objected to the Report, but if such objection occurred, Tutor and the GreenStar Rep would have been required to engage an independent accountant to review the Pre-Tax Profits Report and determine whether it was accurate or inconsistent with the underlying financials.[81] Similarly, a provision which requires the parties to engage an independent accountant to resolve the objection to the financial reports is a useful way to engage a third-party to resolve the conflict and potentially prevent a party from filing premature litigation on the matter.

When the independent third-party accountant or the court reviews the earnout language after the dispute has arisen, it is helpful if the purchase agreement provides statements of the parties' intent as to how the earnout would be calculated. Additionally, hypothetical examples which illustrate how the earnout is calculated and how floors, caps, carrybacks, offset rights and other complex numerical formulas are applied can be helpful to the third-party accountants who are brought in to resolve the disputes in the financial reports. Such language and hypothetical examples can provide additional color and meaning to obscure and complex terms of the acquired business and may not be completely understood by the reviewing accountant or court.

c. Select the Correct Metric to Measure the Earnout

When the parties negotiate an earnout provision, the earnout needs to be based on the financial metric which most accurately tracks the value which the earnout is attempting to measure, whether it be revenues, sales, EBITDA, pre-tax profits, etc. The 2018-19 ABA M&A Committee's Private Target Deal Points Study reported that the two most common metrics for basing the earnout are revenues and earnings/EBITDA.[82] The seller will likely prefer to base the earnout target on revenues as the revenue metric is less affected by labor, costs and expenses and is therefore less subject to buyer manipulation. On the opposite hand, the buyer would disfavor-revenues-based targets for the same reasons, but the buyer will especially disfavor a revenues-based target if the seller remains involved in the business post-closing as the seller may likely not be incentivized to control costs and expenses and may likely be incentivized to grant unprofitable deals to customers in order to achieve a revenues-based target.

[81] *Tutor Perini*, WL 5035567 at *1-3.

[82] 29% of the earnout targets were Revenues-based, 31% were based on Earnings/EBITDA.

A similar issue presented itself in *Vista Outdoor, Inc. v. Reeves Family Trust*.[83] In July of 2015, Vista purchased Jimmy Styks, a paddleboard manufacturer, for $40 million and a three-year profits-based earnout, with a $10 million cap the first year, and up to $15 million in years two and three.[84] The first year post-closing it appeared that the gross profits would be too low to meet the earnout target and achieve the $10 million cap, so the two co-founders of Jimmy Styks procured a plan whereby they would purchase almost $4 million of Jimmy Styks decals in order to meet the gross profits target required to achieve the $10 million cap.[85] When Vista learned of this plan, it blocked the proposed decal purchase, fired the co-founders and brought action for declaratory relief.[86] While the Court granted summary judgement in favor of Vista and the co-founders scheme did not result in the increased earnout amount, as they hoped[87], the *Vista* cases illustrates some of the potential issues which may arise if the incorrect metric, or a metric which is subject to manipulation, is selected to measure the earnout.

d. **Dispute Resolution Mechanisms**

Given the prevalence of earnout disputes, purchase agreements often contain a mandatory arbitration provision, which are generally respected by the courts. In Texas an arbitration clause which incorporates the Judicial Arbitration and Mediation Society ("***JAMS***") Rules "presents clear and unmistakable evidence that the parties agreed to arbitrate arbitrability" and has resulted in a dismissal of litigation in favor of arbitration so that an arbitrator could determine the arbitrability of the dispute.[88]

Parties who want to avoid the arbitration provision specified in the purchase agreement may argue that the dispute does not implicate the issue which the contract requires to be arbitrated or resolved by a neutral accountant. Additionally, a party who desires to avoid the agreed-upon dispute resolution procedure can argue that the dispute at issue is beyond the expertise of the neutral accountant and, instead, requires a judicial evaluation as courts are reluctant to allow accountants to resolve earnout disputes if the parties dispute more than just the calculation of the earnout.[89]

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[83] 2018 WL 3104631 (U.S. District Court, S.D.N.Y. 2018).

[84] *Id*. at *1.

[85] *Id*.

[86] *Id*.

[87] *Id*. at *1-2.

[88] *Id.* at *13.

[89] *See Fit Tech, Inc. v. Bally Total Fitness Holding Corp.*, 374 F.3d 1, 8 (1st Cir. 2004) ("[I]t makes no sense to assume that accountants would be entrusted with evaluating disputes about the operation of the business in question. Yes, operational misconduct may well affect the level of earnings and therefore the schedules, but the misconduct itself would not be a breach of proper accounting standards. Nor would one expect accountants to have special competence in deciding whether business misconduct unrelated to accounting conventions was a breach of contract or any implied duty of fair dealing."); *See generally Hodges v. Medassets Net Revenue Systems, LLC*, WL 476140 (N.D. Ga. 2008) (the court concluded that a mandatory ADR provision requiring an independent accountant "does not apply to the claim of contract and duty breach at issue here; rather, it only applies to disputes over objections to earn-out consideration calculations and not claims regarding Defendants' software sales business.").

5. TAX CONSIDERATIONS

When an installment sale occurs, gain on the sale may be spread over the period during which the installment payments are received, rather than being taxed in the year of sale. Generally, the installment method of reporting applies where at least one payment is to be received after the close of the taxable year in which the disposition occurs.[90] The installment method also applies to contingent payment sales.[91] An interest charge may be applied to an installment sale where the taxpayer has over $5,000,000 of outstanding installment obligations at the close of a given tax year.[92] The rules related to the installment method and the interest charge, and their application to earnouts, are beyond the scope of this paper. However, they require careful consideration in consultation with a tax adviser.

6. SUMMARY & CONCLUSION

In summary, an earnout is deal mechanism in an M&A Transaction which sets forth the criteria upon which the buyer will pay additional consideration to the seller upon the occurrence of specific post-closing events. An earnout is a particularly useful when the buyer and seller have differing views on the value of the estimated future performance of the business or the likelihood that a specific event will occur in the future related to the acquired business. While earnouts are a deal mechanism used to address disagreements which arise during the negotiation of the purchase price, earnouts commonly result in post-closing disputes over the calculation of the earnout or the earnout itself. These disputes often lead to litigation, arbitration or mediation. To reduce the risks these kinds of issues, it is critical that the buyer and seller bargain for and agree to specific and deal-contextualized provisions and procedures relating to the calculation of the earnout, the parties' respective earnout-related obligations, and the mechanism to dispute the calculation of each party's earnout-related obligation.

[90] *See* I.R.C. § 453(b)(1). Exceptions to the definition of installment sale include the sale of personal property of a kind which is required to be included as inventory if on hand at the end of the tax year, and most dealer dispositions. I.R.C. § 453(b)(2). Further, the taxpayer may elect out of the installment method under I.R.C. § 453(d)(1).

[91] *See* Treas. Reg. § 15a.453-1(c)(1). The seller also has the option to elect out of the installment method in a contingent payment sale. Temp. Reg. §§ 15a.453-1(c)(1) and (d)(3).

[92] I.R.C. § 453A(c).

EXHIBIT A

Earnout Agreement

This Earnout Agreement ("***Agreement***") is made as of __________ by ____________, a ____________("***Buyer***"), and ________, ("***Seller***"), and ___________________, as Seller's Representative. This is the Earnout Agreement referred to in the Purchase Agreement (the "***Purchase Agreement***"), dated ____________, between Buyer and Sellers. Capitalized terms used in this Agreement and not otherwise defined herein have the respective meanings given to them in the Purchase Agreement.

RECITALS

A. The Purchase Agreement provides that a portion of the Purchase Price is to be calculated and paid as an earnout.

B. Buyer and Sellers have agreed that the determination and payment of the earnout contemplated by the Purchase Agreement is to be in accordance with the terms of this Agreement.

NOW, THEREFORE, the parties, intending to be legally bound, agree as follows:

1. DEFINITIONS

For purposes of this Agreement, the following terms have the meanings specified or referred to in this Paragraph 1:

"***Adjusted EBITDA***"—EBITDA, adjusted as described in the last sentence of this definition and by excluding the effects of any of the following to the extent otherwise included in consolidated earnings from operations:

(a) gains, losses or profits realized by the Acquired Company from the sale of assets other than in the ordinary course of business and any "extraordinary items" of gain or loss (as determined in accordance with GAAP);

(b) any management fees, general overhead expenses, or other intercompany charges, of whatever kind or nature, charged by Buyer to the Acquired Company, [except that Buyer may charge interest on any loans or advances made by Buyer or its Affiliates to any of the Acquired Company in connection with their business operations at a rate of _____ percent per annum];

(c) any legal or accounting fees and expenses incurred in connection with this Agreement, the Purchase Agreement or the Contemplated Transactions; and

(d) [Add any other items to be excluded].

In determining consolidated earnings from operations, the purchase and sales prices of goods and services sold by the Acquired Company to Buyer or its Affiliates, or purchased by the Acquired Company from Buyer or its Affiliates, shall be adjusted to reflect the amounts that the Acquired Company would have received or paid if dealing with an independent party in an arm's-length commercial transaction.

"***Affiliate***"—with respect to any entity, an entity that directly or indirectly controls or is controlled by, or is under common control with, as the case may be, the relevant entity.

"***Computation Notice***"—as defined in Paragraph 3(a).

"***EBITDA***"—consolidated earnings from operations of the Company and its Subsidiaries, as determined in accordance with GAAP as consistently applied by the Company, before consolidated interest, taxes, depreciation, and amortization of the Company, in each case, as determined in accordance with GAAP as consistently applied by the Company.

"***Earnout Amount***"—an amount equal to (a) Adjusted EBITDA for the Earnout Period, less (b) the Threshold Amount.

"***Earnout Payment***"—as defined in Paragraph 2(a).

"***Earnout Period***"—the fiscal year ending __________.

"***Income Statement***"—as defined in Paragraph 3(a).

"***Independent Accountants***"—as defined in Paragraph 3(d).

"***Objection Notice***"—as defined in Paragraph 3(c).

"***Payment Rate***"—___________ percent.

"***Threshold Amount***"—the amount of $________________.

2. EARNOUT PAYMENT

(a) Buyer shall pay to Seller's Representative on behalf of Seller an amount equal to (i) the Earnout Amount, multiplied by (ii) the Payment Rate, but only if the Earnout Amount is a positive number (the "***Earnout Payment***"). If the Earnout Amount is a negative number, no Earnout Payment shall be made. The Earnout Payment will be paid by Buyer within 30 days after the final determination of the Earnout Amount. Notwithstanding any provision

in this Agreement to the contrary, in no event will the Earnout Payment exceed $____________.

(b) Seller shall not be entitled to any interest on the Earnout Payment under this Agreement.

(c) Upon notice to Seller's Representative specifying in reasonable detail the basis therefor, Buyer may set off any amount to which it claims to be entitled from Seller, including any amounts that may be owed under Article __ of the Purchase Agreement or otherwise, against amounts otherwise payable under this Agreement. The exercise of such right of setoff by Buyer in good faith, whether or not ultimately determined to be justified, will not constitute a default under this Agreement, regardless of whether Seller disputes such setoff claim, or whether such setoff claim is for a contingent or unliquidated amount. Neither the exercise of, nor the failure to exercise, such right of setoff will constitute an election of remedies or limit Buyer in any manner in the enforcement of any other remedies that may be available to it.

3. PROCEDURE

(a) Buyer shall maintain separate accounting books and records for the Acquired Company during the Earnout Period. Promptly following the end of the Earnout Period, Buyer shall prepare (i) a consolidated income statement of the Company and its Subsidiaries for the Earnout Period, which shall be prepared in accordance with GAAP as consistently applied by the Company (the "***Income Statement***"), and (ii) a computation of EBITDA and Adjusted EBITDA, showing separately each of the adjustments made to EBITDA to arrive at Adjusted EBITDA (the "***Computation Notice***"). Buyer shall deliver the Income Statement and the Computation Notice to Seller's Representative within 45 days following the end of the Earnout Period.

(b) Upon execution of such access letters as may be reasonably required by Buyer, Seller's Representative and its Representatives shall be given reasonable access during reasonable business hours to (and copies of) all Buyer's and its Representatives' books, records, and other documents, including work papers, worksheets, notes, and schedules used in preparation of the Income Statement and its computation of EBITDA and Adjusted EBITDA in the Computation Notice for the purpose of reviewing the Income Statement and the Computation Notice, in each case, other than work papers that Buyer considers proprietary, such as internal control documentation, engagement planning, time control and audit sign off, and quality control work papers.

(c) If, within 45 days following delivery of the Income Statement and the Computation Notice to Sellers' Representative, Sellers' Representative has not given Buyer notice of an objection as to any amounts set forth on the Income Statement or the computation of EBITDA or Adjusted EBITDA in the Computation Notice (which notice shall state in reasonable detail the basis of Seller's Representative's objection) (the "***Objection Notice***"), the Adjusted EBITDA as computed by Buyer will be final, binding, and conclusive on the parties.

(d) If Seller's Representative timely gives Buyer an Objection Notice, and if Seller's Representative and Buyer fail to resolve the issues raised in the Objection Notice within

30 days after giving the Objection Notice, Seller's Representative and Buyer shall submit the issues remaining in dispute for resolution to [name of individual] in the [location] office of [name of accounting firm] (or, if [name of individual or name of accounting firm] is providing accounting services to Buyer or is otherwise unable or unwilling to serve in such capacity, a recognized national or regional independent accounting firm mutually acceptable to Buyer and Seller's Representative) (the "***Independent Accountants***").

(e) The parties shall negotiate in good faith in order to seek agreement on the procedures to be followed by the Independent Accountants, including procedures with regard to the presentation of evidence. If the parties are unable to agree upon procedures within 10 days of the submission to the Independent Accountants, the Independent Accountants shall establish such procedures giving due regard to the intention of the parties to resolve disputes as promptly, efficiently, and inexpensively as possible, which procedures may, but need not, be those proposed by either Buyer or Seller's Representative. The Independent Accountants shall be directed to resolve only those issues in dispute and render a written report on their resolution of disputed issues with respect to the Income Statement and the Computation Notice as promptly as practicable but no later than 60 days after the date on which the Independent Accountants are engaged. The determination of Adjusted EBITDA by the Independent Accountants will be based solely on written submissions of Buyer, on the one hand, and Seller's Representative, on the other hand, and will not involve independent review. Any determination by the Independent Accountants will not be outside the range established by the amounts in (i) the Income Statement and the computation of EBITDA and Adjusted EBITDA in the Computation Notice proposed by Buyer, and (ii) Seller's Representative's proposed adjustments thereto. Such determination will be final, binding, and conclusive on the parties.

(f) If the computation of Adjusted EBITDA is submitted to the Independent Accountants for resolution:

(i) Seller's Representative and Buyer shall execute any agreement required by the Independent Accountants to accept their engagement pursuant to this Paragraph 3;

(ii) Seller's Representative and Buyer shall promptly furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the disputed issues as the Independent Accountants may request and are available to that party or its accountants or other Representatives, and shall be afforded the opportunity to present to the Independent Accountants, with a copy to the other party, any other written material relating to the disputed issues;

(iii) the determination by the Independent Accountants, as set forth in a report to be delivered by the Independent Accountants to both Seller's Representative and Buyer, will include all the changes in the Income Statement and the computation of EBITDA and Adjusted EBITDA in the Computation Notice required as a result of the determination made by the Independent Accountants; and

(iv) Seller and Buyer shall each bear one-half of the fees and costs of the Independent Accountants; provided, however, that the engagement agreement referred to in

clause (i) above may require the parties to be bound jointly and severally to the Independent Accountants for those fees and costs, and in the event Seller or Buyer pay to the Independent Accountants any amount in excess of one-half of the fees and costs of their engagement, the other party(ies) agree(s) to reimburse Seller or Buyer, as applicable, upon demand to the extent required to equalize the payments made by Seller and Buyer with respect to the fees and costs of the Independent Accountants.

4. MISCELLANEOUS

(a) Efforts. From the Closing Date of the Purchase Agreement through the end of the Earnout Period, Buyer shall, and shall cause its Affiliates to, use commercially reasonable best efforts in the context of successfully managing the business of the Acquired Company to achieve and pay the Earnout Payment in full.

(b) Entire Agreement. This Agreement, together with the other agreements among the parties executed and delivered concurrently herewith, supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter and constitutes a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter.

(c) Modification. This Agreement may only be amended, supplemented, or otherwise modified by a writing executed by the parties.

(d) Assignments and Successors. No party may assign any of its rights or delegate any of its obligations under this Agreement without the prior consent of the other parties. Any purported assignment of rights or delegation of obligations in violation of this Paragraph 4(d) will be void. Subject to the foregoing, this Agreement will apply to, be binding in all respects upon, and inure to the benefit of the heirs, executors, administrators, legal representatives, successors, and permitted assigns of the parties.

(e) Governing Law. All matters relating to or arising out of this Agreement and the rights of the parties (whether sounding in contract, tort or otherwise) will be governed by and construed and interpreted under the laws of the State of __________ without regard to conflicts of laws principles that would require the application of any other law.

(f) Remedies Cumulative. The rights and remedies of the parties are cumulative and not alternative.

(g) Jurisdiction; Service of Process. Except as otherwise provided in this Agreement, any Proceeding arising out of or relating to this Agreement shall be brought in the courts of the State of __________, County of __________, or, if it has or can acquire jurisdiction, in the United States District Court for the __________ District of __________, and each of the parties irrevocably submits to the exclusive jurisdiction of each such court in any such Proceeding, waives any objection it may now or hereafter have to venue or to convenience of forum, agrees that all claims in respect of such Proceeding shall be heard and determined only in any such court, and agrees not to bring any Proceeding arising out of or relating to this Agreement in any other court. Each party acknowledges and agrees that this Paragraph 4(f) constitutes a voluntary and bargained-for agreement between the parties.

Process in any Proceeding referred to in the first sentence of this Paragraph 4(f) may be served on any party anywhere in the world. Any party may make service on any other party by sending or delivering a copy of the process to the party to be served at the address and in the manner provided for the giving of notices in Section ____ of the Purchase Agreement. Nothing in this Paragraph 4(f) will affect the right of any party to serve legal process in any other manner permitted by law or at equity.

(h) Mediation/Arbitration. In the event of any dispute arising under or relating to this Agreement, the parties hereby agree to mediate any such dispute before a mediator from the Judicial Arbitration and Mediation Services ("***JAMS***"). If the dispute is not resolved within thirty (30) days from the request for mediation, such dispute shall be submitted to binding arbitration in accordance with the Commercial Arbitration Rules of JAMS ("***JAMS Rules***") before the arbitrator. The parties shall attempt to mutually select the arbitrator. In the event they are unable to mutually agree, the arbitrator shall be selected by the procedures prescribed by the JAMS Rules.

(i) Attorneys' Fees. Except as provided in clause (iv) of Paragraph 3(f), in the event any Proceeding is brought in respect of this Agreement, the prevailing party will be entitled to recover reasonable attorneys' fees and other costs incurred in such Proceeding, in addition to any relief to which such party may be entitled.

(j) No Waiver. Neither any failure nor any delay by any party in exercising any right, power, or privilege under this Agreement or any of the documents referred to in this Agreement will operate as a waiver of such right, power, or privilege, and no single or partial exercise of any such right, power, or privilege will preclude any other or further exercise of such right, power, or privilege or the exercise of any other right, power, or privilege. To the maximum extent permitted by applicable Legal Requirements, (i) no claim or right arising out of this Agreement or any of the documents referred to in this Agreement can be waived by a party, in whole or in part, unless made in a writing signed by such party; (ii) a waiver given by a party will only be applicable to the specific instance for which it is given; and (iii) no notice to or demand on a party will (A) waive or otherwise affect any obligation of that party or (B) affect the right of the party giving such notice or demand to take further action without notice or demand as provided in this Agreement or the documents referred to in this Agreement.

(k) Amendment. This Agreement may be amended only if the amendment is in a written document signed by the parties hereto.

(l) Notices. All notices and other communications required or permitted by this Agreement shall be given in accordance with Section ___ of the Purchase Agreement.

(m) Severability. If any provision of this Agreement is held invalid or unenforceable by any court of competent jurisdiction, the other provisions of this Agreement will remain in full force and effect. Any provision of this Agreement held invalid or unenforceable only in part or degree will remain in full force and effect to the extent not held invalid or unenforceable.

(n) Time of Essence. With regard to all dates and time periods set forth or referred to in this Agreement, time is of the essence.

(o) Counterparts/Electronic Signatures. This Agreement may be executed in one or more counterparts, each of which will be deemed to be an original copy and all of which, when taken together, will be deemed to constitute one and the same agreement, and will be effective when counterparts have been signed by each of the parties and delivered to the other parties. A manual signature on this Agreement, which image is transmitted electronically, will constitute an original signature for all purposes. The delivery of copies of this Agreement, including executed signature pages where required, by electronic transmission will constitute effective delivery of this Agreement for all purposes.

[Signature pages to follow]

IN WITNESS WHEREOF, the parties have executed and delivered this Agreement as of the date first written above.

BUYER:

By: ______________________________
Name: ____________________________
Title: _____________________________

SELLER:

By: ______________________________
Name: ____________________________
Title: ____________________________

SELLER'S REPRESENTATIVE:

By: ______________________________
Name: ____________________________
Title: ____________________________