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WHY EARN-OUTS ARE STILL HOT IN A HOT MARKET

BY TED D. ROSEN, ESQ.

As deal values have risen over the last several years, buyers, especially private equity buyers, are concerned that they are overpaying in the face of stiff competition from strategic buyers, family offices, foreign buyers and other private equity funds. In addition, fears that a strong economy will grow weaker over the next several quarters raises concerns about the sustainability of EBIDTA growth. And for further consideration, as private equity firms are increasingly contributing more capital in their acquisitions, they need to be more conscious of the valuations being paid. As a result, it is increasingly more likely that buyers will structure deals with earn-out provisions both as a tool to delay payment of the purchase price, and to shift to the seller the risks of the uncertain future associated with high growth and unreliable financial projections. Incentivizing sellers and management with earn-outs and executive compensation linked to post-closing performance aligns both parties to continued success in a transaction, especially in the lower and middle market.

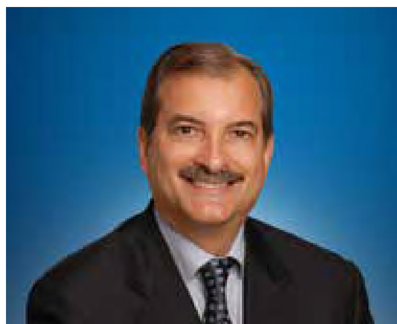
The last few years have also seen an increase in growth-oriented investments. Unsurprisingly, according to the ABA Private Target Mergers and Acquisitions and Deal Point Studies, there has also been a steady increase in earn-out provisions from

2013 to 2017. The increase in earn-out provisions in private transactions over the last 4 plus years can likely be attributed to increases in private equity deal count, growth investments, dry powder, equity contributions and the higher multiples highlighted above. As more private equity firms have dry powder to deploy, the likelihood of these firms acquiring more growth-oriented business with fluctuations in financial projections increases. In these types of deals, sellers will likely view the recent uptick in financial projections as the "go forward value" of the company. On the other hand, buyers may want to protect themselves from the risk that the increased financial performance is an outlier.

Thus, because of how hot earn-out provisions have become in this hot market (according to Pitchbook, in the first half of 2018 deal value is up 16% and deal count is up 5% compared to first half of 2017), buyers and sellers must understand the key issues that will come up in negotiating earn-out provisions.

Devil is in the Details

One of the core tenets in having a successful earn-out provision is making sure that the calculation of the earn-out is clear and quantifiable. Whether the earn-out is based on gross or net earnings, EBITDA, adjusted EBITDA or other factors (gross-margin, sales thresholds, etc.) or even a combination of a multiple of factors, good drafting is the key to avoiding post-closing disputes. The earn-out calculation should be reviewed with transactional accountants to advise on the appropriate methodology and language being



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used. EBITDA may need to be adjusted so that it does not reflect extraordinary or non-recurring items, and items unrelated to the performance of the target company or business. In addition, consideration should be given as to whether the earn-out is capped or open-ended. Further, should the earn-out be accelerated in the event the company is sold or sales metrics are reached sooner than expected?

Post-Closing Operating Restrictions

It is also important to ensure that earn-out provisions clearly illustrate how the target will operate post-closing. From the private equity buyer's perspective, they want the freedom to operate the business going forward in a manner that maximizes profitability but allows them to introduce improvements to processes or best practices that may not match sellers' past practices. Buyers may agree to not, directly or indirectly, take any actions in bad faith that would have the purpose of avoiding or reducing any of the earn-out payments hereunder. However, buyers will also want sellers to acknowledge that buyer has no obligation to operate the business in order to achieve any earn-out payment or to maximize the amount of any earn-out payment. Sellers on the other hand, may seek a laundry list of protections relating to the operation of the business post-closing, such as: requiring buyer to operate the business consistent with past practices, requiring buyer not to divert sales or impose overhead or management fees and expenses, and / or requiring buyer to spend a certain amount of money on marketing expenses. Veto rights may also be requested by sellers on certain post-closing actions (debt, salaries, etc.) to ensure that their earn-out potential is not unnecessarily diluted. In addition, buyers will seek the right to set-off against earn-out payments any claims they have relating to seller's beaches under the acquisition agreement. From a private equity buyer's perspective this right is a powerful tool to protect the buyer where earnings and performance do not meet expectations, in addition to rights the buyer may have under representation and warranty insurance policies or other contractual indemnification rights.

Term of Earn-Out

The term of the earn-out will impact what protections a seller may request. Earn-outs can range from one to five years. If the earn-out is substantial or payable over several years, sellers may seek affiliate guaranties, collateral and escrows.

Dispute Resolution

In terms of dispute resolution in earn-outs, we typically state in the

purchase agreement that an agreed independent third party--usually an accounting firm--act as the arbiter of the dispute. This option may provide a faster and hopefully more economical method to resolve disputes. The dispute resolution language may provide for the independent accountant's fees and expenses to be allocated so that the party whose calculation of EBITDA (or other agreed upon financial metric) is closer to the findings of the independent accountant pays a smaller percentage of the fees. To disincentivize a seller from challenging an earn-out calculation made by buyer, the buyer may want the party whose calculation is furthest from the determination of the independent accountant to pay all of the independent accountant's fees and expenses. Alternatively, sellers may seek to have the buyer share the fees equally in the event of a dispute.

Conclusions

Earn-outs are a useful tool in facilitating deals provided that each party is aware of the risks, and has clarity as to the key metrics involved. As these provisions have become increasingly more common in today's economy, it has also become increasingly more important to get these provisions right, and to understand the deal points associated with such provisions, both for buyers and sellers. ■

Trends in M&A Provisions: Earnout Provisions, by Daniel Avery, dated July 10, 2018, Bloomberg Law.

Please contact Ted D. Rosen, Esq. at ted.rosen@akerman.com or 212-259-8711, if you have any questions regarding this article. This article is intended for discussion purposes only and should not be relied on without obtaining legal counsel.