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Corporate M&A Advisor

Finance and Transactions Group

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December 1997

STRUCTURING EARNOUTS IN M&A TRANSACTIONS

Merger and acquisition activity involving middle market companies has escalated in the nineties, and businesses will likely continue to grow through mergers and acquisitions into the next millennium. As businesses in all industries feel the pressure to stay competitive, the question of whether to acquire or be acquired is regularly being asked and answered by management.

In structuring an acquisition, purchasers and sellers both must make the key determination of the value of the target being acquired. Purchasers and sellers can often have legitimate differing opinions as to the current and future value of the target. Moreover, where a target's management will operate the acquired business after closing, the acquiror will likely desire a purchase price mechanism to give management the incentive to transition the target smoothly and to continue growing earnings after closing. In such circumstances, the purchase price is often based on a fixed amount payable at closing, together with an "earnout" whereby the seller can "earn" a higher purchase price based on the post-closing performance of the target.

Earnouts are used as purchase price alternatives for various reasons: the parties may have based the purchase price on differing assumptions; the purchaser may desire to incentivize management of the target; or the purchaser may simply be trying to accommodate the seller's unrealistic expectations as to the target's future earning potential. In any event, an earnout is a useful tool to assist in bridging the gap between the expectations of a purchaser and a seller, particularly when the principals of the seller will continue to operate the acquired business.

Earnout Methodology

An earnout is, in its simplest form, a method by which the parties to an acquisition determine whether (and to what extent) a seller is entitled to additional purchase price consideration after closing based upon the future performance of the product, product line, division, or target acquired. Earnouts are often used where sellers are individuals who are selling their business and will be employed by purchaser going forward. Thus, these sellers have a vested interest in the future of the target — both as a source of additional purchase price and as employees. Earnouts are also used where a seller sells a product or product line, and the performance of the particular product or line is the basis for additional contingent consideration to the seller. There is no predetermined pattern for an earnout. Each earnout formula is different because the concerns and contingencies facing the parties in every transaction vary, and the parties are free to construct the earnout in any way they wish. In structuring an earnout, however, there are several components which are present in every earnout formula, and each of these components must be identified and addressed by the parties. These components include (i) the earnings indicator, (ii) the source of the earnout, (iii) the value of the earnout and the method of payment and (iv) termination provisions.

The Indicator

The most commonly used indicators of post-closing earnings are net income and EBITDA[1] or EBIT[2]. Purchasers often favor using net income as the measure of the success of the acquired business, product, or product line because it will more closely track a purchaser's internal method of measuring profitability going forward. Sellers, however, desire to use EBITDA or EBIT as the earnings indicator to avoid possible distortions between pre- and post-closing operations and capital structure by deducting interest, taxes, depreciation, and amortization from earnings.

The Source Once the parties establish a method of measuring future profitability, the next step is to determine what should be used as the source of the revenue. For example, if a purchaser is acquiring a specific product or product line, the earnout is often tied to revenue generated by that particular product or product line rather than such purchaser's entire net income across all products or lines. Where a purchaser acquires substantially all of a target's assets or all of the stock of a target, the source of revenue would likely be either the division of such purchaser created after the asset acquisition or the entire target which becomes a subsidiary of such purchaser after closing. Basing the earnout source on these "entities" induces a target's former owners and management to assist in a smooth transition and to continue to take an interest in such target's performance because the payment of any additional contingent purchase price is directly tied to post-closing performance.

Value; Payment

Once the indicator and the source of the earnout are agreed upon, the next step is to determine the value of the earnout. The potential value of the earnout is determined by tying the earnout payment to the indicator (*e.g.*, net income, EBITDA, or EBIT). As discussed earlier, earnouts are structured for several reasons — the parties have based the purchase price on different assumptions; the purchaser wants to incentivize the target's management; or the purchaser is trying to accommodate a seller's unrealistic expectations as to the target's future earning potential. In any case, the value of the earnout can be established as a percentage of the indicator (usually where the earnout is structured as an incentive or to accommodate a seller's expectations), or as a multiple of the indicator (*e.g.*, 5x EBIT for the particular period).

The parties must also decide if they will prorate the earnout if the predetermined performance criteria or targets are only partially met. However, the parties must determine at the outset whether the performance criteria are being established as hurdles which must be cleared before any payment is due to a seller or whether such established criteria are merely goals used for incentive purposes. Such goal-oriented earnouts are designed to permit pro rata earnout payments based upon a seller's achievements of certain predetermined goals at a particular point in time. It is not unusual for the parties to negotiate a middle ground by formulating a minimum hurdle which must be reached before any earnout payment is made to a seller, with pro rata payments made available thereafter. It is also not unusual for earnouts to be capped at a particular dollar amount or percentage of the indicator.

The earnout can be paid in many forms (*e.g.*, cash, stock, or a mix of cash and stock) depending upon the particular agreement of the parties. A purchaser can use its stock as consideration for the earnout to encourage the seller to focus on the long-term growth of the target, and thus, such purchaser as a whole.

***Termination*.**

Another key component of any earnout is determining when the obligations of a purchaser to continue to make payments and a seller's contractual rights to receive any additional payments cease (*i.e.*, the termination provisions). The two most common termination provisions are tied to the passage of time (temporal) or the happening of a specific event. Temporal earnout termination mechanisms are often introduced where the parties (particularly a seller) are comfortable that the projected value of the business can be realized over a predetermined time period (*e.g.*, three years). On the other hand, a purchaser may want to tie the earnout to the period during which it intends to incentivize former owners and management (the length of which may also be tied to the term of their employment agreements).

Alternatively, an event-specific termination is exactly that — the earnout terminates upon the occurrence of a particular event which the parties either foresee or acknowledge as an event that should cause termination of future payment obligations. The particular events will vary from transaction to transaction. For instance, the parties may agree that the earnout terminates upon a change in control of the purchaser, the sale of the business, division or product line originally acquired or, where the former owners and management enter into employment agreements with a purchaser, the termination of such employment.

One of the most crucial terms negotiated in connection with the earnout's termination is the option of a purchaser to buy out its remaining earnout obligation in a lump sum should the need or desire arise. Earnouts, by their nature, often restrict the flexibility of a purchaser over an acquired target's operations (*e.g.*, capital expenditures and management selection). Moreover, potential suitors may refuse to acquire assets encumbered by an earnout. Thus, in order to provide a purchaser with the flexibility it desires and to limit a seller's ability to "hold out" when approached by a purchaser seeking to buy out the remaining term of an earnout, purchasers often attempt to negotiate upfront buyout options for the earnout. The buyout option price is often tied to historical payments made to a seller under the earnout formula or an appraisal of the business.

Other Considerations

Accounting Issues

As discussed earlier, earnouts are tied to a predetermined formula based upon future earnings or other similar financial goals regarding a target. Thus, when establishing the indicator (*e.g.*, net income or EBITDA), it is essential that the parties agree upon the financial or accounting components of the formula. For instance, the parties may agree to use net income as the indicator, but they need to look beyond net income to make sure that there are no disagreements as to the revenue, cost, and expense components which make up net income. From a seller's perspective, it is critical that the accounting methodology for determining net income, among other things, is consistent pre- and post-acquisition. Simply agreeing that the financial statements of target will be prepared in accordance with GAAP[3] is insufficient. GAAP is a set of malleable principles rather than hard-and-fast rules, and these principles allow the preparer of financial statements to choose among alternative accounting treatments on a number of issues. Depending upon the particular alternative used to value inventory, for instance, adjustments to GAAP may allow a purchaser to manipulate the results of the earnout. Thus, the seller should establish the specific methodology of the post-closing accounting treatment of items of particular concern. The seller must also pay particular attention to the treatment of specific transaction-related charges that may be incurred prior to closing, but booked after closing, and thus negatively impact the earnout. Also, the earnout formula should exclude amortization of goodwill as a result of the acquisition, as well as amortization of goodwill as a result of future acquisitions where the target is used as a vehicle for the acquisition. Similarly, post-closing changes in depreciation methods may impact the earnout calculation whether implemented unilaterally by a purchaser or as a result of changes in GAAP.

The transaction documents should also specify not only the methodology used in calculating the earnout but also the party charged with making such calculation based on the agreed-upon methodology. Depending upon the nature of the transaction, either the purchaser or the seller may be in the best position to calculate the earnout. However, purchasers, not surprisingly, usually insist on having their accountants perform the calculations. Regardless of which side makes the calculation, the parties may dispute the accounting methods and adjustments used in reaching the earnout number. It is, therefore, critical that the party not making the earnout calculation have a right to audit the records and information used by the other party to calculate the earnout amount, and that the parties have an opportunity to resolve the difference amicably. Thus, dispute resolution becomes an important factor in all earnouts, and a mechanism should be carefully established for challenging the initial calculation and, preferably, arbitrating any disputes (*e.g.*, hire two independent accounting firms to redo the calculations and use the average determined by such firms).

Synergies

When establishing the components of net income or EBITDA, the parties must also attempt to allocate the benefits of the bargain that result from the acquisition. For example, after closing, a target may share with a purchaser and its affiliates certain costs and fees that the target used to bear on its own. Moreover, each party may benefit from the synergies created by the acquisition (*e.g.*, consolidated accounting and administration). Thus, where it is anticipated that a purchaser will provide post-closing services to a target, or incur expenses that benefit such target exclusively, these costs should be passed along to the target. Since any costs passed along to the target could negatively impact the earnout, the seller must negotiate the specific allocation to it, as well as the costs, of services and expenses on an arm's-length basis to ensure that the target is not being allocated and paying for services and expenses from which it receives no benefit. Particular areas of concern for a target are the allocation of executive compensation, management fees, taxes and insurance and other general and administrative expenses. From a purchaser's perspective, it should not simply give away the synergies from the transaction directly to a seller (*i.e.*, the savings related to reductions in overhead, personnel and other expenses should not completely and solely benefit the target's bottom line (thus boosting the earnout potential) simply because a purchaser added value to a target by the acquisition). To the extent savings are easily and clearly identifiable (*e.g.*, reductions in administrative charges, legal and marketing costs, and information systems), the parties should exclude these savings from the earnout indicator.

Post-Closing Operations

A purchaser and seller must also specifically address the method of operation of the target's business (or product or product line) post-closing. Sellers typically desire to avoid any post-closing change in the operations that will impact their ability to receive the full earnout. On the other hand, a purchaser typically wants the flexibility to operate and integrate the target into its business. As a result of these tensions, the parties must address how various aspects of the target's business will be treated post-closing and how any agreed-upon treatment will affect the earnout.

Of particular concern to a seller is the management of the target post-closing. For example, the surviving management team may consist of former shareholders and management of the target who participated in negotiating the earnout formula. Where a purchaser has the ability to change the composition of the target's management team, a seller may seek vesting or accelerated payment of all or part of the earnout at the time such change is implemented, arguing that such a change directly affects its ability to earn the full earnout amount.

Similarly, a seller's ability to maximize its earnout is directly affected if: (i) the target's operations do not remain consistent; (ii) the target is not assured of adequate capital for continued operations and potential expansion; (iii) the target is not given the flexibility to take advantage of future opportunities; or (iv) the target does not have control over capital expenditures. As discussed earlier, however, a purchaser needs operational flexibility regarding the target and its business. A middle ground in negotiating these operational areas of concern is either to exclude from the earnout calculation expenses above a certain threshold amount or to set a fixed cost for these expenses that will be charged back to the target business.

For instance, marketing expenses of the target can be excluded from the earnout if they exceed a two-year historical average of marketing expenses. As a result, a purchaser will have more flexibility to mass-market the product while a seller can be more certain that what it may view as excessive marketing expenses will not negatively

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impact its earnout. Similarly, if a purchaser uses the target as a vehicle to expand its business by means of other acquisitions, income and expenses arising out of such acquisitions will likely need to be excluded from the earnout.

Some concerns that are shared by both a purchaser and a seller include how to adequately address product overlap and the potential shifting of income in the earnout calculation. With respect to products of a target business that overlap with those of a purchaser, it may be necessary to consolidate sales staff, office and manufacturing facilities, and other similar areas. While taking advantage of operational synergies resulting from such consolidation, the parties must not improperly affect the earnout by shifting sales to one party or the other.

Additionally, any shift in income or expenses by a party can similarly manipulate the earnout. Where earnout payments are based on performance over specified time periods (*e.g.*, annually based on interim results), there is the potential for either party to book income or expenses for a particular period in either a prior or a subsequent period. Such a shift could negatively impact the earnout indicator for that period and result in a distorted calculation of the earnout. Because of these and similar concerns, the parties must thoughtfully anticipate these and other concerns specific to their respective businesses that are likely to arise after the closing.

Certain Tax Issues

Earnout payments can be characterized for tax and accounting purposes as follows: (i) payment of deferred, contingent purchase price; (ii) payment of ordinary compensation to a seller by a purchaser; or (iii) a combination of purchase price and compensation. If the earnout represents deferred, contingent purchase price, a seller will generally be taxed on the earnout payment as capital gain at a maximum long-term capital gain rate. The maximum long-term capital gain rate applicable to noncorporate taxpayers for assets held more than 18 months is 20%. An individual seller whose earnout payment is treated as compensation (whether as a result of continued employment or a noncompetition agreement) is subject to tax on ordinary income at a federal income tax rate of up to 39.6%. Earnout payments will likely be characterized as compensation where one of the following circumstances is present: (a) a seller performs services for a purchaser post-closing (whether pursuant to an employment or consulting agreement); (b) a seller's right to receive all or a portion of the earnout payments is expressly conditioned on such seller's continued employment with the purchaser; or (c) the seller and the purchaser enter into a noncompetition agreement. For tax purposes, a seller will be able to deduct compensation payments; however, additional purchase price payments are not deductible as an expense, but will increase the purchaser's basis in the property acquired. Due to the substantial difference in the tax consequences to the parties arising from such characterization, the parties must evaluate the tax treatment of the payments as well as the structure of any continuing service arrangement between sellers and purchasers.

Another important tax consideration for earnouts is imputed interest. As discussed above, an earnout may be characterized for tax purposes as the payment of contingent deferred purchase price. Unlike a transaction where the purchase price is fixed but deferred, purchasers and sellers negotiating an earnout often fail to provide for interest on the future contingent earnout payments. Where the parties are silent on interest in the earnout formula, they run the risk that, under the tax rules, the Internal Revenue Service will impute interest with respect to each contingent payment. Thus, the interest imputed with respect to each future payment (at a rate usually tied to the then-applicable federal rate) decreases the aggregate purchase price (as well as the income which is taxable at capital gains rates) and creates interest income to a seller in the amount of the imputed interest (which is taxable at higher ordinary income rates). This tax result may be more favorable to a purchaser because it can take current interest deduction in the amount of the imputed interest. Consequently, it is likely not equally embraced by a seller since such seller is not likely prepared for the possibility of recognizing ordinary income equal to the amount of the imputed interest. This potential bombshell is easily diffused by the parties with advance planning.

Since earnouts are the prevalent device to pay higher acquisition prices with little or no additional leverage, careful planning and drafting of earnout provisions is essential. A well-drafted earnout permits both sellers and purchasers to maximize the value of an acquisition and provides a blueprint for the successful relationship between a target's essential management and the acquiror.

[1]Earnings before interest, taxes, depreciation and amortization.

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[2]Earnings before interest and taxes.

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[3]Generally accepted accounting principles.

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