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Earnouts on the Rise in M&A Transactions

What Purchasers, Sellers and Lenders Need to Know

In 2008 and 2009 to date, the volume of merger and acquisition activity dramatically fell due to a variety of factors. In some cases, it was the underlying recent performance of the target company coupled with a lack of going-forward visibility. In other cases, the value gap was too wide between what a buyer was willing to pay and what a seller was willing to accept. Finally, many transactions were not consummated because financing was simply not available.

Many M&A professionals expect credit to remain tight and performance visibility to remain challenging through the remainder of 2009. As parties strive to get deals done in the midst of these difficult issues, using an earnout is an effective technique to fill the gap in the capital structure and close the gulf between a seller's value expectations and a buyer's price point. This article summarizes key elements in designing an earnout and addresses important considerations from the perspective of various deal constituents.

Designing an Earnout

When considering an earnout, both parties need to agree upon the key value drivers in the transaction. These drivers must both measure the value of the target company and motivate the target management to perform for the buyer. In many cases, the key value driver is cash flow. Value drivers also include EBITDA, sales, net income, customers, product development, research or intellectual property. A buyer generally would prefer to have the earnout structure based as far down the income statement as possible (i.e., tested on net income). However, the seller would prefer that the earnout be tested at the top of the income statement or at the gross sales line. This is because the gross sales test is more objective, and there are fewer things a buyer can do to reduce the earnout. For example, in a net income based earnout, a buyer could add significantly to marketing or R&D expenses and therefore reduce the earnout. While these expenditures may create long-term benefits for the buyer, they can reduce an earnout tied to net income. One common market compromise for testing an earnout is gross profit.

The parties must agree upon the specifics, method and timing of the calculation of the earnout. In many cases, we recommend attaching detailed accounting principles and sample calculations to the contract. Similar specificity in drafting the rules that apply to the calculation of the earnout and dispute resolution procedures will also help to avoid disagreements, or to resolve them efficiently and effectively.

Some new trends that we are seeing in designing earnouts include a buyout option for buyers and

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acceleration or early payout rights for sellers. A buyout option (often calculated using a net present value formula) can be particularly helpful if a buyer has an opportunity to sell the company before the end of the earnout term, or if the buyer is interested in consolidating or merging the target into another business. Correspondingly, some sellers have been seeking acceleration or early payment provisions to protect themselves from post-closing changes that may hinder achieving the earnout. For example, acceleration may apply if certain key members of the management team are terminated or if there is a material change in the manner of operation of the business.

Key Considerations for Sellers

The seller must be confident that there is a clear standard for valuing the earnout and that it can control the outcome based on the metrics. This reduces the opportunity of the purchaser to manipulate or skew the company's numbers and reduce the earnout. The seller also needs to give consideration to what, if any, restrictions it would like to impose on the buyer's management of the company during the earnout period. The seller further needs to understand how and when it will get paid when the earnout is, in fact, earned. Part of that equation is specifying if the earnout will be the obligation of the target operating as a subsidiary or the buyer, and if the buyer is willing to provide any credit enhancement or guarantees.

Additionally, the seller must understand any conditions that the lenders to the target and/or the buyer will seek to impose upon payment of the earnout; for example, will the senior or mezzanine lenders of the buyer require subordination of the earnout payments? Finally, if the buyer is not going to provide a guarantee of the earnout payment, the seller might want to require an equity commitment, letter of credit or other credit enhancement to support the earnout obligations.

Key Considerations for the Buyers

The earnout needs to be tied to what the buyer believes are the key value drivers upon which it is basing the transaction. If the test is financial, then the earnout needs to be structured accordingly. If the test is tied to customers, product development or intellectual property (e.g., attainment of FDA approval in a biotech or pharmaceutical deal), each of those matters need to be given careful consideration and woven into the earnout methodology. While the seller will try to impose restrictions on the purchaser's operation of the business so as not to interfere with achieving its earnout payments, the buyer also needs to make sure it has retained sufficient flexibility to effectively run the business and maximize its value. Further, the buyer needs to make sure it has built into its future cash flows and financing structures the ability to make the earnout payments when they become due.

Lenders' Considerations

Today, virtually all lenders consider contingent payments to a seller akin to equity. Accordingly, lenders give careful thought to the covenants and conditions that must be met to permit earnout payments. Alternatively, if there is some concern about the buying entity's ability to make the earnout payments, lenders might require an equity commitment from the sponsor or parent that ensures sufficient funding to make the earnout payments and stay within covenant compliance. Finally, lenders often insist on a formal subordination agreement between the seller and the lender that blocks earnout payments upon specified events so the failure to pay will not be actionable by the seller for an agreed-upon time period.

Tax Considerations

There are a variety of tax considerations that have to be addressed when structuring an earnout, and tax advisors play a critical role in the process. The parties should agree on how the earnout payments will be allocated. In many cases, earnout payments will be considered "goodwill" payments since they are not adjustments to balance sheet items. Another tax consideration is the installment sale reporting requirements. Under the installment method, a seller reports its taxable gain ratably with each payment it receives, rather than reporting all of the gain in the year of disposition. Thus, the installment sale method can have the effect of deferring the seller's tax obligations or gains from the sale, with a number of exceptions and limitations. Further, whether or not there will be imputed interest income to the seller and related interest deductions to the buyer must be considered and addressed.

Conclusion

Earnouts can be useful tools in filling any gaps in the capital structure and bridging the chasm between a seller's value expectations and what a buyer is willing to pay for a business. They need to be carefully structured to capture the key value drivers and be carefully woven into the capital structure of the target and/or the buyer. We expect the next wave of M&A transactions to feature earnouts as key parts of the consideration.

If you have any questions or comments, please call your Vedder Price contact or any member of our Finance and Transactions Group identified on the following page.

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