AMERICAN BAR ASSOCIATION ANNUAL MEETING 2004
EARNOUTS IN BUSINESS ACQUISITIONS:
A PRACTICAL SOLUTION OR A TRAP FOR THE UNWARY?
SATURDAY, AUGUST 7, 2004, 10:30 A.M. TO 12:30 P.M.

PROGRAM MATERIALS

1. Informal survey questionnaire regarding use of earnouts circulated to members of the Negotiated Acquisitions Committee.

2. Current draft of Earnout Agreement being reviewed and updated by Negotiated Acquisitions Committee Task Force revising the Model Stock Purchase Agreement.

3. Copy of PowerPoint slides for presentation by Garrett DeVries.

4. Copy of PowerPoint slides for presentation by Bill Payne.

5. Copy of PowerPoint slides for presentation by Den White.


7. Earnouts Bibliography.


10. Resource Article – “Earnouts: an Outline of Key Issues” authored by Mark D. Gerstein for a Practicing Law Institute Conference on “Acquiring or Selling the Privately Held Company” and reprinted with his permission. (Available only on CD ROM)
Questionnaire Regarding Earnouts

1. Have you represented a client regarding the use of an earnout in an M&A transaction?
   Yes __________
   No ___________ (If you answered no, stop here)

2. In your experience, is the level of negotiation involved in reaching agreement on an earnout:
   Light __________
   Moderate __________
   Heavy __________

3. In the last three years have you seen the use of earnouts in M&A transactions:
   Increase __________
   Decrease __________
   Stay the same ______

4. Of the total number of earnouts in which you have been involved, approximately what percentage have yielded a material payout for the seller:
   0 % ______
   1-10% ______
   10-50% _____
   50% plus ___

5. Of the total number of earnout transactions in which you have been involved, approximately what percentage have resulted in a significant dispute over the amount of the earnout payment or application of the earnout terms?
   0 % ______
   1-10% ______
   10-50% _____
   50% plus ___
6. In your experience, by what means have you seen earnout related disputes resolved:
   
   accountants ________
   mediation ________
   arbitration ________
   litigation ________

7. If a client is considering the use of an earnout, do you actively counsel them regarding the pitfalls of earnouts:

   always ________
   sometimes ________
   never ________
Introductory Note

This model earnout agreement has been prepared by the Task Force on Revisions to the Model Stock Purchase Agreement of the Negotiated Acquisitions Committee of the ABA Section of Business Law and is subject to change prior to publication of the Revised Model Stock Purchase Agreement.

In general, the terms of an earnout agreement are largely dictated by the specific facts and circumstances of the situation. As a result, this model earnout agreement does not attempt to provide a “one size fits all” solution. Rather, it provides a basic framework for an EBITDA-based earnout agreement and addresses many alternative provisions and related issues in the commentary. In addition, this agreement does not reflect all of the terms that might be contained in a buyer’s first draft. In drafting an earnout agreement, the drafter will need to consider his or her specific facts and circumstances and should carefully consider the issues raised in the commentary to this agreement.

Earnout Agreement

This Earnout Agreement (“Agreement”) is entered into this_______ day of __________, 20__, by and between _________ (“Seller”) and ___________ (“Buyer”).

RECITALS

A. Seller has this date sold to Buyer the Acquired Companies (hereinafter defined) pursuant to a Stock Purchase Agreement dated __________, 20__ by and between Seller and Buyer (the “Purchase Agreement”).
B. The Purchase Agreement provides that a portion of the purchase price is to be calculated and paid as an earnout based upon the EBITDA (hereinafter defined) generated by the Acquired Companies over the Term (hereinafter defined).
C. Seller and Buyer have agreed that determination and payment of the earnout contemplated by the Purchase Agreement is to be in accordance with the terms of this Agreement.

COMMENT:

General. Earnout agreements make a portion of the purchase price for an acquired company contingent upon the acquired company achieving specified milestones during a specified period of time after closing. The contingent purchase price is typically “earned” and paid when the acquired company achieves the milestones. If the acquired company does not achieve any milestones, no earnout payments are typically paid.
Earnouts are different than purchase price adjustments. A purchase price adjustment is designed to adjust the purchase price after closing to reflect the difference between the parties’ pre-closing estimate of the amount of assets, liabilities, net working capital or other financial metric of an acquired company that will exist at closing and the amount that actually existed at closing. As a result, a purchase price adjustment may increase or decrease the purchase price. By contrast, an earnout is generally only used to increase the purchase price in the future.

Earnouts typically arise out of an attempt to bridge a gap between a seller’s perception of the value of a business and a buyer’s desire to pay a conservative purchase price to reduce the risk of overpaying for the business. This valuation gap is often exacerbated when the seller values the business based on an aggressive projection of future results and the buyer values the business based on limited or poor historical results or on a more conservative projection of future results. Valuation gaps often arise in situations such as:

- entrepreneurial stage companies, as entrepreneurs often have an inflated perception of the value of the business and limited operating history;
- companies financially dependent on new product lines or technologies that have not been proven in the market;
- turnaround acquisitions where the seller will likely argue that historical financial information is not an accurate measure of the value of the business; and
- hot market sectors where differences in valuation may be heightened.

Earnouts can also be used in other situations. For example, an earnout might be used to retain and motivate key employees who were former owners of the acquired company.

Earnouts are more complicated when the acquired company will be fully integrated into the buyer’s business or when the product lines of the buyer and the acquired company are essentially the same. If the acquired company is fully integrated into the buyer or the product lines are too similar, there is greater opportunity for the buyer to manipulate the financial performance of the acquired company to the detriment of the seller. In addition, earnouts are more risky to the seller as the period of time to achieve the milestones increases because unforeseen changes in circumstances may make achieving the milestones significantly more difficult or impossible.

Earnout agreements are most often used when the acquired company is privately held. In general, if the acquired company is public, market valuations and control premiums usually solve the problem of adequately valuing the acquired company.

An earnout should be structured as a non-transferable contract right. This may avoid characterization of the earnout as a security subject to registration under federal or state securities laws. This may pose problems for a corporate seller who may desire to assign the earnout to its stockholders or legal successor.
If an earnout may be used in a transaction, any party retaining an investment banker or financial advisor should be careful in reviewing and negotiating the investment banker’s or advisor’s engagement agreement. If the engagement agreement has a fee that is paid upon successfully completing an acquisition or sale and is calculated based on the purchase price of the acquired company, the buyer or seller will likely want to specify in the agreement that the calculation of the success fee only includes earnout payments that are actually paid or received. Many engagement agreements use a very broad calculation of the purchase price of an acquired company to determine the success fee and may include the maximum amount of contingent earnout payments as part of the purchase price, regardless of whether they are actually earned and paid.

Although the concept of a contingent purchase price based upon future performance may seem simple, drafting an agreement that adequately addresses the parties’ concerns may be very difficult. This agreement presents an EBITDA-based earnout and the commentary highlights some of the difficulties and drafting issues associated with this contingent purchase price arrangement. Although some practitioners believe that earnout agreements are invitations to future litigation, others have used them successfully.

NOW, THEREFORE, in consideration of the premises and of the respective covenants and provisions herein contained, Seller and Buyer agree as follows:

ARTICLE I.
DEFINITIONS

For purposes of this Agreement, the terms listed below have the following meanings. Other terms not listed below are defined elsewhere in this Agreement.

1.1. Acquired Companies. The companies acquired by Buyer pursuant to the Purchase Agreement.
1.2. Annual Payment Rate. [Forty] ([40]% percent.
1.3. Cumulative Earnout Amount. With respect to any Earnout Period, an amount equal to (i) the Earnout Amount applicable to such Earnout Period, plus (ii) the Earnout Amount applicable to any previous Earnout Period (if any), whether positive or negative.
1.4. Cumulative Payment Rate. [Sixty] ([60]% percent.
1.5. EBITDA. Shall have the meaning assigned to such term in Article III.
1.6. Earnout Amount. With respect to each Earnout Period, an amount equal to (i) the EBITDA for the Acquired Companies, less (ii) the Hurdle EBITDA.
1.7. Earnout Period. Each fiscal year (or other period) identified in Section 2.2.
1.8. Final Earnout Amount. An amount equal to (i) the Cumulative Earnout Amount at the end of the Term, multiplied by (ii) the Cumulative Payment Rate.
1.9. Hurdle EBITDA. With respect to each Earnout Period, the amount of EBITDA set forth opposite such period in Section 2.2.
1.10. Prior Period Positive Total Earnout Amount. With respect to any Earnout Period, the sum of the Total Earnout Amounts applicable to previous
1.11. *Term.* The period commencing on the date hereof and continuing until ____________, 20__.  

1.12. *Total Earnout Amount.* With respect to any Earnout Period, an amount equal to (i) the Cumulative Earnout Amount for such period, less (ii) Prior Period Positive Total Earnout Amount for such period.

**ARTICLE II. EARNOUT PAYMENT**

2.1 *Earnout Payment.*

(a) For each Earnout Period during the Term, Buyer shall pay to Seller an amount (the “Annual Earnout Payment”) equal to (i) the Total Earnout Amount, multiplied by (ii) the Annual Payment Rate, if the foregoing product is a positive amount. The Annual Earnout Payment will be paid to Seller within [thirty] (30) days after the amount of EBITDA has been determined conclusively for a particular Earnout Period.

(b) At the end of the Term, if

(i) the Final Earnout Amount is less than or equal to zero, then the Seller shall pay to Buyer an amount equal to the cumulative Annual Earnout Payments that have been paid by Buyer to Seller;

(ii) the Final Earnout Amount is greater than zero and is greater than the amount of the cumulative Annual Earnout Payments that have been paid by Buyer to Seller, then Buyer shall pay Seller an amount equal to (1) the Final Earnout Amount, less (2) the amount of cumulative Annual Earnout Payments that have been paid by Buyer to Seller;

(iii) the Final Earnout Amount is greater than zero and is less than the amount of the cumulative Annual Earnout Payments that have been paid by Buyer to Seller, then Seller shall pay Buyer an amount equal to (1) the amount of cumulative Annual Earnout Payments that have been paid by Buyer to Seller, less (2) the Final Earnout Amount; or

(iv) the Final Earnout Amount is greater than zero and equal to the amount of the cumulative Annual Earnout Payments that have been paid by Buyer to Seller, then no payments shall be made.

All payments under this Section 2.1(b) shall be paid within [thirty] (30) days after the date of determination of the Final Earnout Amount.
Neither Buyer nor Seller shall be entitled to any interest on any payments under this Agreement.

2.2. **Period for Payment.** The periods for calculation and payment of the Annual Earnout Payment shall be as follows:

<table>
<thead>
<tr>
<th>Fiscal Year (or other period)</th>
<th>Hurdle EBITDA Amount</th>
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2.3. **Right of Setoff.** Buyer shall have the right to withhold and set off against any amount due hereunder the amount of any claim for indemnification or payment of damages to which Buyer may be entitled under the Purchase Agreement or any other agreement entered into pursuant to the Purchase Agreement.

COMMENT:

**Overview of the Structure of this Agreement.** This earnout agreement presents an earnout based upon a percentage of actual EBITDA in excess of a specified target or “hurdle” EBITDA amount and is payable over a period of time. The annual payments are treated as progress payments toward the finally determined earnout amount. The agreement uses a lower payment percentage on an annual basis (i.e., 40%) than is ultimately to be applied (i.e., 60%) in order to cushion the buyer's risk of future EBITDA shortfalls and the possibility that the seller will not make the buyer whole for any overpayments when the final earnout payment is calculated. The agreement provides for a true up between the annual earnout payments and the finally determined earnout amount at the end of the term. The percentages used in this Agreement are for illustrative purposes only and should not be deemed to reflect standard practice.

The agreement uses mathematical formulas for calculating the annual earnout payments and tracking cumulative EBITDA amounts. In the formulas, Earnout Amount represents the difference between the Hurdle EBITDA and the actual EBITDA of the Acquired Companies and is calculated for each Earnout Period. Cumulative Earnout Amount represents the sum of the Earnout Amounts for the current Earnout Period and all prior Earnout Periods. As a result, Cumulative Earnout Amount represents the aggregate amount by which the EBITDA of the Acquired Companies is either above or below the aggregate hurdles. Prior Period Positive Total Earnout Amount represents the aggregate amount of EBITDA on which the Seller has been paid in prior Earnout Periods. It is necessary to track and cumulate the amount of EBITDA on which the Seller has been paid in prior Earnout Periods so that the Seller does not get paid twice for the same EBITDA. Finally, Total Earnout Amount represents the amount of EBITDA on which the Seller is getting paid in the current Earnout Period and is equal to the Cumulative Earnout Amount less the Prior Period Positive Total Earnout Amount.
While the formulas may not be intuitive at first, they generally make sense when put into a spreadsheet. While some practitioners prefer a less mathematical approach, other practitioners prefer the specificity of precise formulas. Hypothetical examples of the calculation of the earnout payment are attached as Exhibit A and could be included as part of the agreement for illustrative purposes.

**Performance Criteria and Associated Issues.** Earnout payments can be based on a variety of measurable performance criteria. This agreement uses EBITDA; however, other measures involving EBIT, pre-tax net income, gross profit or sales can be used. In addition, the earnout can be structured as a fixed or variable amount to be paid upon achievement of specified milestones, such as completion of specified projects. A number of drafting and business issues will arise depending on the performance criteria used.

From the buyer’s standpoint, using sales as the performance criteria creates a risk that the related cost of sales or other costs are not being taken into account in the earnout calculation. This is especially risky to the buyer if the seller has some operational control over the acquired company after closing and can dramatically increase the cost of sales or other costs to the detriment of the buyer to obtain a higher earnout payment.

The seller may argue for a sales-based approach on the ground that sales are the only readily determinable, externally driven amount; that a sales-based approach is most likely to avoid litigation over the terms of the agreement; and that the buyer (as opposed to the seller) may be in the best position to regulate the cost of sales and other costs. In addition, a sales-based approach often allows the target to be integrated into the buyer’s business without interfering with the earnout mechanics. Because a sales-based approach is the most simple, the parties may desire to use it regardless of the inherent cost control issues.

If an EBIT- or net income-based approach is used instead of EBITDA and the buyer will make an election to treat the stock purchase like an asset purchase under Section 338 of the Internal Revenue Code, the seller should evaluate the need for a pre-acquisition computation of depreciation and amortization because, in most instances, depreciation and amortization on a post-acquisition basis will be increased as a result of the write-up of assets subject to such computations based upon the purchase price in the acquisition transaction. If EBITDA is not used, the parties should also consider, among other issues, the impact of transaction charges booked after closing; the impact of any new indebtedness of the buyer resulting from the transaction; and potential tax rate differentials between the buyer and seller.

**Choosing What Business to Measure.** In addition to choosing a performance measure, the buyer and seller may apply the earnout to the entire acquisition, a portion of it or a single product or may blend it over several entities. A blended measure can ensure that sales are not shifted artificially by the buyer from the target to the buyer’s affiliates, thereby decreasing the seller’s payment.
Subsequent Combinations. If the payment rate concept is utilized and the buyer wants to reserve the right to make other acquisitions that are folded into the acquired company or to combine existing operations with the acquired company, then the definition of Annual Payment Rate can be modified by adding text similar to the following at the end thereof:

In the event that an entity (the “New Entity”) is combined with the Acquired Companies after the date hereof, then the Annual Payment Rate and Cumulative Payment Rate for payments accruing after the combination of the New Entity and the Acquired Companies shall be reduced by multiplying such payment rate by the ratio that annual gross revenues directly arising out of the Acquired Companies as determined for the twelve months immediately before the combination of the New Entity and the Acquired Companies bear to the pro-forma combined gross revenues of the Acquired Companies and the New Entity as determined for the twelve months immediately before such combination.

If, however, the New Entity has a lower gross profit or net income margin, this ratio method could be disastrous to the seller. For this reason, sellers sometimes attempt to prevent such combinations. This position may create tension with a buyer who would prefer the flexibility to integrate operations. In addition, if a business combination occurs shortly before the calculation of an earnout payment, it may not be fair to the seller to reduce the Annual Payment Rate for that earnout payment without prorating for the portion of the earnout period that has already elapsed. The same issue applies to the change to the Cumulative Payment Rate. In lieu of using gross revenues of the Acquired Companies and New Entity to adjust the payment rate, the parties may want to use EBITDA or another financial metric of the Acquired Companies and New Entity to adjust the payment rate.

Escrowing Payments. Section 2.1 contemplates that the earnout payment will be made periodically with an eventual adjustment (plus or minus) at the end of the term. A buyer may be more comfortable in providing for an annual (or other periodic) determination of the earnout payment with the amount thereof to be set aside in escrow until the end of the term with a one-time settlement. This structure would obviate a need for the buyer to call upon the seller to refund money which had previously been paid to the seller on the earnout.

Other Ways to Structure Payments. In addition to periodic payments or lump sum payments, earnouts may be paid on the occurrence of a specified event, or the agreement may include provisions for partial payments which are prorated if the benchmarks or goals are only partially achieved. Generally, inclusion of such provisions are a matter of negotiating leverage. Earnout agreements may also specify bonus payments for exceeding goals. If bonus payments are included, the buyer may want to set a cap on the bonus payments.
**Closing Date Audit.** Section 2.2 contemplates that Hurdle EBITDA will be calculated for each fiscal year during the term. If the parties desire that the initial period commence as of the closing date (which is unlikely to coincide with a fiscal year end), then there should be a balance sheet audit prepared by the buyer’s accountants as of that date unless the parties are comfortable in relying on unaudited figures as the basis for an opening balance sheet.

**Forms of Earnout Consideration.** This agreement anticipates a cash payment of the earnout value. Using the buyer's stock rather than cash raises a number of issues, including, but not limited to, the date or method for determining the per share price at which the stock is valued; whether the shares will (or need to be) registered under federal or state securities laws; voting and control issues; and for exchange-listed or Nasdaq-listed stock, authorization of the stock to be issued and potential stockholder approval rules.

**Interest on Payments.** No interest is included on the deferred payments under this agreement. A seller may wish to bargain for interest from the closing date on the basis that the earnout payments represent deferred purchase price or for a default interest clause if the earnout payments are not made timely. For associated tax issues, see the discussion on tax principles in the following commentary. In addition, the buyer may want to include interest on the amount of any money refunded to the buyer at the end of the term. If the seller receives interest on earnout payments under the agreement, the buyer should be careful to ensure that it recoups any interest payments it made if the seller owes buyer at the end of the term.

**Size and Duration of Earnouts.** The percentage of the purchase price represented by earnouts varies widely. However, an earnout payment representing less than 10-20% of the purchase price may not be worth the time and effort to negotiate the earnout agreement or the risk of future litigation over the earnout. If the earnout payment represents a significant portion of the purchase price, the risk to the seller may be too great. The duration of an earnout agreement also varies, but often ranges from two to five years.

**Setoff Rights.** The setoff rights in Section 2.3 provide buyer a broad right to set off any claim for indemnification or payment of damages to which buyer may be entitled under the stock purchase agreement or other ancillary agreements against any amounts due to seller under the earnout agreement. Seller may object to the setoff rights for a variety of reasons, including that they permit set off of non-final claims against amounts due under the earnout. For a complete discussion of setoff rights and related issues, see Section 11.8 of the Revised Model Stock Purchase Agreement and related commentary.

**Litigation Risks and Caselaw.** Because the failure to achieve a sufficient level of EBITDA to entitle the seller to an earnout payment could result in litigation, the parties should carefully consider and potentially document who is responsible for generating sales, what resources the buyer will be required to provide to the acquired company and what duties, efforts and cooperation the buyer and seller must provide to each other and
to the acquired company. While seemingly innocuous, clauses that provide that the buyer
will use reasonable efforts to maintain the business of the acquired company or
reasonably cooperate with the seller may be litigation traps for the buyer. As a result, the
buyer should carefully consider the language of any such clauses and consider including
termination provisions if the acquired company suffers significant losses, faces
significant liability or otherwise performs substantially below expectations or if the
acquired company becomes subject to legal regulations that adversely impacts its
business. The following cases highlight litigation issues arising under earnouts.

In *Richmond v. Peters, et al.*, 166 F.3d 1215 (6th Cir. 1998), the plaintiff sold his
business to defendant with the price and payments to be determined, in substantial part,
by reference to the profits of the continuing business in excess of a base-level amount.
The agreement between them provided that the business was to be managed in
accordance with “sound business practices.”

Plaintiff claimed that defendant breached their agreement and breached a fiduciary
duty owed by defendant to the seller. On motion for judgment as a matter of law after
plaintiff presented its case, the trial court ruled that Ohio law imposed no fiduciary duty
upon defendant and that plaintiff had presented no evidence that defendant had breached
any provision of the agreement.

The facts of the case should be reviewed with respect to the contract claim. It is
significant, however, that the trial court found, and the appellate court agreed that, at least
under Ohio law, the earnout agreement created no implied fiduciary duty between the
parties.

(D. Kan. Feb. 11, 2003), the plaintiffs sold their boat manufacturing business to
defendants. Pursuant to the purchase agreement, up to $5.2 million of the purchase price
was to be earned based on the profits of the acquired company after closing. One of the
plaintiffs remained as the president of the acquired company and ran its operations after
closing. The plaintiffs sued the defendants for breach of the express terms of the
purchase agreement and the duty of good faith and fair dealing implied by the terms of
the purchase agreement. The purchase agreement, which contained the earnout
provision, was governed by Delaware law.

At trial, a jury found for the plaintiffs and awarded them $2.5 million under the
earnout. The defendants appealed for judgment as a matter of law that the plaintiffs were
not entitled to recover any damages under the earnout. The defendants asserted that the
plaintiffs’ claim for breach of the implied covenant of good faith and fair dealing fails as
a matter of law because it requires the court to add wholly new terms to the purchase
agreement and to rewrite or supply omitted terms in violation of Delaware law. The
court found that principles of good faith and fair dealing permit a court to imply certain
terms to a purchase agreement to honor the parties’ reasonable expectations when the
agreement omits the terms from the literal text of the agreement, but the terms can be
implied from the remaining text.
At trial, the jury was presented evidence that the defendants (i) undermined plaintiff’s position as president of the acquired company post-closing, (ii) abandoned the acquired company’s pre-closing brand name entirely, (iii) mandated production of the defendants’ brands after closing to the detriment of the acquired company’s pre-closing brands, and (iv) reimbursed the acquired company only for its actual costs for manufacturing the defendants’ brands, which harmed the realization of plaintiffs’ profit-based earnout. The court concluded that if the jury had found that the defendants engaged in such conduct, then the jury could conclude that such conduct was inconsistent with the spirit of the agreement governing the earnout consideration and that such conduct constituted a breach of the implied covenant of good faith and fair dealing. In other words, the jury could reasonably conclude that if the parties had considered such conduct at the time of negotiating the purchase agreement, the parties would have agreed to provisions prohibiting such conduct.

This case is important because it provides sellers with a legal theory to claim a breach of an earnout agreement based on conduct that was not prohibited by the express terms of the agreement. In addition, while the case was decided by a district court in Kansas, the court applied Delaware law, which is frequently chosen by parties outside the State of Delaware as neutral governing law.

One way for a buyer to attempt to mitigate against the inherent litigation risk is to include a provision whereby the seller acknowledges that the buyer has the right to run the acquired company in the buyer’s sole discretion and whereby the seller waives any implied fiduciary duties or implied duties of good faith and fair dealing. The following is an example of a pro-buyer provision:

The Seller acknowledges that (i) upon the closing of the transactions contemplated by the Purchase Agreement and except as expressly provided to the contrary in this Agreement, Buyer has the right to operate the Acquired Companies and Buyer’s other businesses in any way that Buyer deems appropriate in Buyer’s sole discretion, (ii) Buyer has no obligation to operate the Acquired Companies in order to achieve any Earnout Amount or to maximize the amount of any Earnout Amount, (iii) Buyer is under no obligation to continue to manufacture the Acquired Companies' product line(s), (iv) the Earnout Amount is speculative and is subject to numerous factors outside the control of Buyer, (v) there is no assurance that Seller will receive any Earnout Amount and Buyer has not promised nor projected any Earnout Amount, (vi) Buyer owes no fiduciary duty or express or implied duty to the Seller, including an implied duty of good faith and fair dealing, and (vii) the parties solely intend the express provisions of this Agreement to govern their contractual relationship. Seller hereby waives any fiduciary duty or express or implied duty of Buyer to the Seller, including an implied duty of good faith and fair dealing.
By including such a provision, the buyer runs the risk that the seller will reject the provision and demand extensive negative covenants regarding the operation of the acquired company after closing. In addition, in the event of litigation, the seller would likely challenge the enforceability of the waivers.

**Complications to Integrating an Acquired Company.** An earnout can complicate the transition of an acquired company from the seller to the buyer. A buyer will generally focus on changing certain aspects of the business in order to properly integrate it into the buyer’s business. On the other hand, the seller has a need to control the carryover functions of the acquired company to maximize the earnout or to make its computation easier. The disparate incentives that can be created by an earnout agreement are frequently neglected when negotiating an earnout. Attention of the seller to short-term targets that can support or increase the earnout payment may be inconsistent with the long-term goals or objectives of the buyer, thereby creating an agreement that pits the seller’s objectives against those of the buyer. The buyer and seller must examine the impact of earnout performance goals not only for the financial impact on both parties, but also within the context of the buyer’s overall goals and objectives and whether the earnout performance goals are consistent with these goals or in conflict with them. Many earnout agreements never make it into the final agreement because it is often very difficult for the buyer to give the seller enough control post-closing to achieve the seller’s performance goals out of concern over conflicting objectives.

**Tax Issues.** Regardless of how the earnout is structured, the tax effects of the earnout must be considered. The original issue discount rules of the Internal Revenue Code require that some portion of the deferred consideration, if made in stock, must be allocated to interest, reportable as such by the seller and deductible as such by the buyer. The remaining portion of the stock is generally treated as additional consideration emanating from the original purchase. The IRS has issued ruling guidelines relating to the treatment of this contingent stock in Rev. Proc. 84-42, 1984-1 C.B. 52.

In the case of a taxable transaction, the regulations dealing with installment sale transactions require an interest computation (if none is stated) and also require that, if deferral of gain recognition is permitted, for purposes of determining the timing of recognition of gain, the seller's tax basis in the stock originally transferred is to be allocated, in part, to the potential contingent payments to be received in the future. See Regulation § 15A.453-1(c). When the total amounts of payments are finally determined at the end of the term, the tax basis is reallocated and adjustments are made to the seller’s taxable income in the final year of the term.

Amounts to be received under a normal earnout agreement may be so incapable of being valued as of a closing date that they meet the “not reasonably ascertainable” test. In that case, the “open transaction” theory of *Burnet v. Logan*, 283 U.S. 404 (1931), could apply to defer income recognition until the year in which the amount of the payment becomes ascertainable or, possibly, until the year of receipt.
Earnouts can also be used in tax-free acquisitions. However, the use of property other than buyer stock is limited or even prohibited in certain tax-free reorganizations. The use of too much property other than stock, commonly referred to as “boot,” may destroy the tax-free status of the reorganization.

**Incentivizing Ongoing Management.** This agreement has been structured as additional consideration for the seller for the purchase of the acquired company by the buyer. It is not unusual for earnout agreements to include additional compensation for ongoing management as well. If such management includes non-stockholders of the seller or, if fewer than all of the stockholders of the seller benefit from the agreement,

- it is more likely that the recipients of the payments will be treated as having ordinary income for such payments rather than capital gain;
- it is less likely that the seller, if a corporation, will also have a taxable event by reason of such payments; and
- it is more likely that the buyer will be entitled to a compensation deduction rather than being required to include this amount in the basis of the purchased stock.

Creation of a parallel management bonus pool is another way to harmonize incentives for non-stockholder managers or those with little equity in the seller. If the agreement is intended to include an incentive for ongoing managers, it is critical to tie the earnout payment to performance goals which are under the control of the managers.

**Industry Specific Legal Issues.** The structure of a post-closing earnout payment must be considered particularly carefully to ensure it does not violate industry specific fraud and abuse laws. For example, in the health-care industry, federal fraud and abuse laws are designed to prevent certain activities under Medicare and Medicaid, including, in part, improperly receiving remuneration for patient referrals or the provision of items or services. If an earnout payment is linked to the undertaking of these types of activities, it would be prudent to specifically confirm with health-care law counsel that they do not pose fraud and abuse concerns.

**ARTICLE III. COMPUTATION OF EBITDA**

3.1 **Manner of Computation.** For purposes of this Agreement, “EBITDA” of the Acquired Companies for any fiscal year shall mean their consolidated earnings from operations before interest, taxes, depreciation and amortization, calculated as if they were being operated as a single separate and independent corporation. EBITDA shall be determined in accordance with U.S. generally accepted accounting principles (GAAP) as consistently applied by Seller as determined by the firm of independent certified public accountants engaged by Buyer for purposes of its own audit (“Buyer’s Accountants”). In determining such EBITDA:
(a) EBITDA shall be computed without regard to “extraordinary items” of gain or loss as that term shall be defined in GAAP;
(b) EBITDA shall not include any gains, losses or profits realized from the sale of any assets other than in the ordinary course of business;
(c) No deduction shall be made for any management fees, general overhead expenses or other intercompany charges, of whatever kind or nature, charged by Buyer to the Acquired Companies, except that Buyer may charge interest on any loans or advances made by Buyer to the Acquired Companies in connection with its business operations at a rate of ___%;
(d) No deduction shall be made for legal or accounting fees and expenses arising out of this Agreement or the Purchase Agreement;
(e) The purchase and sales prices of goods and services sold by the Acquired Companies to Buyer or its affiliates or purchased by the Acquired Companies from Buyer or its affiliates shall be adjusted to reflect the amounts that the Acquired Companies would have realized or paid if dealing with an independent party in an arm’s-length commercial transaction; and
(f) [Include other desired adjustments to EBITDA].

3.2 Time of Determination.

(a) The EBITDA of the Acquired Companies shall be determined promptly after the close of each Earnout Period by Buyer. Copies of Buyer’s computation of the EBITDA of the Acquired Companies shall be submitted in writing to Seller and, unless Seller notifies Buyer within forty-five (45) days after receipt of the computation that it objects to the computation of EBITDA, the computation shall be binding and conclusive for the purposes of this Agreement. Seller shall have access to the books and records (including financial statements) of the Acquired Companies during regular business hours to verify Buyer’s computation of EBITDA.

(b) If Seller objects to Buyer’s computation of EBITDA by notifying Buyer in writing within forty-five (45) days after receipt of Buyer’s computation of EBITDA, the amount of EBITDA for the Earnout Period to which such computation relates shall be determined by negotiation between Seller and Buyer. If Seller and Buyer are unable to reach agreement within thirty (30) business days after such notification, the determination of the amount of EBITDA for the period in question shall be submitted to ______________, independent certified public accountants (“Independent Accountants”) for determination, whose determination shall be binding and conclusive on the parties. If the computation of EBITDA for an Earnout Period is submitted to the Independent Accountants for resolution, then:
   (i) the Seller and Buyer shall execute any agreement(s) required by the Independent Accountants to accept their engagement pursuant to this Section 3.2(b);
(ii) the Buyer shall promptly furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the computation of EBITDA for such Earnout Period as the Independent Accountants may request and are available to Buyer, and shall be afforded the opportunity to present to the Independent Accountants, with a copy to Seller, any other written material relating to the computation of EBITDA for such Earnout Period; and

(iii) Seller and Buyer shall each bear fifty percent (50%) of the fees and costs of the Independent Accountants for such determination, provided, however, that the engagement agreement(s) referred to in subpart (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 pays to the Independent Accountants any amount in excess of 50% of the fees and costs of their engagement, the other party agrees to reimburse Seller or Buyer, as applicable, to the extent required to equalize the payments made by Seller and Buyer with respect to the fees and costs of the Independent Accountants.

COMMENT:

**Accounting Issues and Disputes.** Disputes regarding the calculation of the earnout may relate to the application of generally accepted accounting principles or GAAP. For example, a change in inventory accounting to bring the seller’s accounting for operations into line with the buyer’s accounting methods would generally be recognized as a substantial change. Other accounting “method” changes can just as easily affect the calculation without constituting changes in the particular generally accepted accounting principles. For example, changes in the method for accounting for bad debts or allocation of corporate overhead may not violate a GAAP standard or represent a change in principles. The buyer may also desire that its generally accepted accounting principles be applied in Section 3.1 as opposed to the seller’s. Negotiating the actual accounting procedures to be utilized post-closing and not relying on generally accepted accounting principles language can minimize accounting disputes. The adjustments to the calculation of EBITDA in Section 3.1 are for illustrative purposes only and should not be viewed as standard adjustments. Any adjustments to the calculation of a financial metric under GAAP are very facts and circumstances specific and should be carefully considered with an accountant.

Section 3.2(b) provides for designated “Independent Accountants” to resolve disputes between the seller and the buyer in the determination of EBITDA. Another alternative is to have the accounting firm selected at the time of the dispute. Instead of using an independent accounting firm, the matter could be referred to the American Arbitration Association or a similar body for resolution.
Section 3.2(b) also provides that the parties will bear the fees and expenses of the Independent Accountant equally. Another alternative is to specify a percentage or amount of EBITDA as a threshold for determining which party pays the fees and expenses of the Independent Accountant. If the amount of EBITDA is understated by the designated percentage or amount or more, then buyer would be required to pay the fees of the Independent Accountant and, if the amount of EBITDA is understated by less than the designated percentage or amount, then seller would be required to pay the fees and expenses of the Independent Accountant.

If the seller is to continue in substantial control of operations of the acquired company, it may be desirable to set up a dispute-resolution mechanism regarding the effect on EBITDA of operational changes. Although the buyer may, in any event, want to implement the changes from an overall business standpoint, with such a mechanism, the seller will be in a position to identify those changes it feels will have an impact on the earnout payment.

If the seller is not to remain in substantial control of the acquired company, then it may be possible to structure a series of “not to exceed” percentages to be applied to the revenues of the business to determine cost of goods sold, SG&A expenses and the like for purposes of the determination of the earnout payment.

If the acquired company is substantially unrelated to the business activities of the buyer, there may be no disputes as to the allocation of revenue. However, where it is anticipated that the acquired company will provide a synergistic effect on the buyer’s operations, there may be disputes as to allocation of additional revenue to the total enterprise. New orders in the same product line from existing customers of the seller are readily allocated to the continuing operations of the acquired company. Orders for the seller’s products from prior customers of the buyer that were not serviced by the seller and orders from completely new customers need to be addressed. Notwithstanding any attention given to these potential problem areas in the agreement, disputes can still arise over failed or deferred deliveries at the end of the earnout term.

The seller may request a provision in the earnout agreement that the seller can prevent the buyer from effecting a subsequent acquisition that would jeopardize the accounting for the continuing operations of the acquired company. For example, the seller may insist on a provision that requires the buyer to maintain the acquired company as a separate subsidiary during the earnout period. Obviously, the buyer will resist such a provision where it would substantially interfere with its business strategy. This may ultimately force the buyer to buy out the seller’s interest in the earnout arrangement.

Section 3.1 could be revised to require an audit of the acquired company. There are practical issues to dealing with such an audit, especially if the acquired company is a very small part of the buyer. Because financial results of the acquired company may be nonmaterial within the scope of a normal audit of the buyer, requiring an audit to verify the earnout results may require significant additional work by the buyer’s accountants.
ARTICLE IV.
MISCELLANEOUS

4.1. *Benefit of Parties and Assignment.* All of the terms and provisions of this Agreement shall be binding upon and inure to the benefit of the parties and their respective permitted successors and assigns. This Agreement shall not be assignable by either party without the prior written consent of the other party.

4.2. *Entire Agreement.* This Agreement contains the entire understanding of the parties with respect to the subject matter hereof and supersedes all prior agreements and understandings between the parties with respect thereto.

4.3. *Counterparts.* This Agreement may be executed simultaneously in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

4.4. *Notices.* Any notice required or permitted to be given hereunder shall be given in accordance with Section ___ of the Purchase Agreement.

4.5. *Waiver of Compliance.* The party for whose benefit a warranty, representation, covenant or condition is intended may, in writing, waive any inaccuracies in the warranties, representations, covenants or conditions contained in this Agreement or waive compliance with any of the foregoing and so waive performance of any of the obligations of the other party hereto and any defaults hereunder, provided, however, that such waiver shall not affect or impair the waiving party's rights in respect to any other warranty, representation, covenant, condition or default hereunder.

4.6. *Index and Captions.* The captions of the Articles and Sections of this Agreement are solely for convenient reference and shall not be deemed to affect the meaning or interpretation of any Article or Section hereof.

4.7. *Governing Law.* This Agreement will be governed by and construed under the laws of the State of _________ without regard to conflicts of laws principles that would require the application of any other law.

IN WITNESS WHEREOF, the parties have hereunto caused this Agreement to be executed in multiple original counterparts as of the date set forth above.

SELLER

By: ________________________________

BUYER

By: ________________________________
COMMENT:

**Early Termination Provisions.** The seller and the buyer may have agreed upon an earnout after a substantial due diligence period by both and after developing a working relationship. This relationship would be jeopardized if there is a change in control of the buyer. Accordingly, the seller may insist on acceleration and full vesting of the earnout payment if there is a change in control of the buyer. In addition, certain “liquidity events,” such as an IPO, a leveraged recapitalization or other events that change the basic financial face of the buyer or the acquired company, may justify the seller, the buyer or both in accelerating the final earnout calculation; in such event, it may be best to negotiate in advance the terms of such accelerated payment.

In addition, the buyer should consider a termination provision if the seller is to remain in control of the acquired company but does not meet certain minimum performance objectives. Those minimum objectives would be lower than those necessary to meet the earnout.

An “exit kickback” may be negotiated in very strong sellers’ markets. An “exit kickback” is generally a payment to the seller if the buyer resells the acquired company within a specified period of time after closing. Although not a true earnout in that it has little to do with an acquired company’s post-closing performance, it is used when the buyer achieves a quick success on the acquisition immediately post-acquisition.

**Miscellaneous Provisions and Dispute Resolution.** This agreement does not contain many of the miscellaneous provisions contained in Article 12 of the Revised Model Stock Purchase Agreement. In drafting an earnout agreement, the drafter should carefully consider which miscellaneous provisions are appropriate in light of the specific facts and circumstances. In addition, the drafter should consider whether to include a alternative dispute resolution mechanism in the earnout agreement. For a discussion of miscellaneous provisions and alternative dispute resolution mechanics, see Article 12 of the Revised Model Stock Purchase Agreement and related commentary.
EXHIBIT A

EXAMPLES OF EARNOUT CALCULATION

Example 1

<table>
<thead>
<tr>
<th>Period</th>
<th>Hurdle EBITDA</th>
<th>Actual EBITDA</th>
<th>Earnout Amount</th>
<th>Cumulative Earnout Amount</th>
<th>Prior Period Positive Total Earnout Amount</th>
<th>Total Earnout Amount</th>
<th>Payment</th>
<th>Aggregate Payments</th>
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In Example 1, the EBITDA of the Acquired Companies fluctuates above and below the Hurdle EBITDA. In the period ending December 31, 2006, the Prior Period Positive Total Earnout Amount prevents the Seller from being paid twice on the $5 of EBITDA earned in the period ending December 31, 2004. At the end of the term, the final earnout payment to the Seller is $1, which is equal to the Cumulative Earnout Amount multiplied by 60% less the Aggregate Payments or (15*.6) – (8) = 1. In this example, the 40% annual payment rate prevents the Buyer from overpaying the Seller.

Example 2

<table>
<thead>
<tr>
<th>Period</th>
<th>Hurdle EBITDA</th>
<th>Actual EBITDA</th>
<th>Earnout Amount</th>
<th>Cumulative Earnout Amount</th>
<th>Prior Period Positive Total Earnout Amount</th>
<th>Total Earnout Amount</th>
<th>Payment</th>
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In Example 2, the EBITDA of the Acquired Companies is greater than the Hurdle EBITDA in each period. As a result, at the end of the term, the Buyer owes the Seller $10, which is equal to the Cumulative Earnout Amount multiplied by 60% less the Aggregate Payments or (50*.6) – (20) = 10.
### Example 3

<table>
<thead>
<tr>
<th>Period</th>
<th>Hurdle EBITDA</th>
<th>Actual EBITDA</th>
<th>Earnout Amount</th>
<th>Cumulative Earnout Amount</th>
<th>Prior Period Earnout Amount</th>
<th>Total Earnout Amount</th>
<th>Payment</th>
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<td>-20</td>
<td>5</td>
<td>-25</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>

In Example 3, the EBITDA of the Acquired Companies is below the Hurdle EBITDA in each period, other than the first period. At the end of the term, the aggregate EBITDA of the Acquired Companies is $20 below the aggregate hurdles. As a result, the Seller must repay the Buyer for the $2 paid to the Seller in the first Earnout Period.
Earnouts

• What are they?

• Why are they used?

Garrett DeVries
Haynes and Boone LLP
Frequently Used In . . .

- development stage companies
- companies with new products or technology
- turnaround situations
- hot market sectors
- private company sellers
- incentivizing ongoing management
Pros

• mechanism to complete a transaction when there are differences in valuation
• provides incentives for seller to stay involved and ensure a smooth transition
• avoids selling at a depressed price
• reflects seller’s updated financial condition
• provides an additional source of financing
Cons

• lack of control by seller
• can restrict business and delay integration
• complex negotiations and drafting
• distraction to buyer
• need to consider how earnout incentivizes each party
• litigation risks
Structure

• milestones can be financial or non-financial
  – sales vs. EBITDA vs. net income
  – project completion
• term ranges, but generally 2-5 years
• percentage of purchase price varies
• periodic payments vs. lump sum payment
• early termination provisions
Is an Earnout Right a Security?

William B. Payne
Dorsey & Whitney LLP
If an earnout is a security

• Registration of the sale may be required (failure to register gives recission rights)
• There may be claims of securities law fraud
• Registration under the 1934 Act may be required
• Qualification of an indenture under the 1939 Act may be required
• There may be 1940 Act concerns
SEC v. W.J. Howey Co., 328 U.S. 293 (1946)

• An investment contract has four principal elements
  – The investment of money
  – In a common enterprise
  – With an expectation of profits
  – To be earned through the efforts of others
SEC “no action” letters on earnouts

- Do not provide exemptive or interpretive relief (courts can decide otherwise)
- Only relate to registration, not the antifraud rules
- May be based on policy decisions, not legal principles
SEC initially declined to provide no action position

- Newell National Company (33-month earning period based on EPS)
- Were only acquiring 95% of the shares
SEC’s subsequent position: employee letters

- Lifemark Corp. (1981)
- Great Western Financial Corp. (1983)
- Lorimar, Inc. (1985)
SEC’s position: property cases

• Star Supermarkets, Inc. (right to receive federal income tax refund—1982)
• Chicago Milwaukee Corporation (proceeds from sale of certain properties—1987)
• Slater Development Corporation (judgment in patent suit—1988)
• Essex Communications Corp. (indemnification escrow—1988)
• First Boston, Inc. (proceeds of the sale of stock—1988)
SEC’s position: true earnouts (not dependent upon employee participation)

• Minnesota Mining and Manufacturing Co. (release of escrowed shares dependent upon revenue goals—1988)
• GID/TL, Inc. (sale of certain products—1989)
• Genentech Clinical Partners (revenues of business sold—1989)
Key principles in no action letters

- Recited as basis for opinion
- Need to be baked into the documents to best assure ability to rely on no-action position
- Integral part of consideration, not an investment
- Right does not represent an ownership interest in the acquiring or acquired business
- Not transferable except by operation of law
- Not certificated
Genentech

- Integral part of the consideration
- Not dependent on operating results of acquirer
- Not transferable except by operation of law
- No voting or dividend rights; do not bear stated rate of interest
- Not certificated
- Do not represent an equity or ownership interest in the acquired or acquiring corporation
SEC position: trusts

- Quanex Corporation (1989)
- Celina Financial Corporation (1993)
- Marriott Residence Inn Limited Partnership II (2002)
Marriott Residence Inn II

- Pro rata participation
- Not transferable except by operation of law
- Not certificated
- No voting or dividend rights; no stated rate of interest
- Not represent an equity or ownership interest
- Amount paid does not depend up the operating results of the resulting entity or any constituent entity
- Other factors
Earnout shares (registered)

• Can be registered at one time (SEC telephone interpretations manual; Pengo Industries, Inc. (May 30, 1980))

• No subsequent prospectus delivery required
Earnout shares (registration exemption)

• Deemed acquired at the initial closing under Rule 144(d)(4)(C) (Pennsylvania Life Company, November 16, 1972)
Other Securities Acts

• 1934 Act
  – Various no action letters
  – Why was 1934 Act request withdrawn in Genentech?

• 1939 Act
  – Various no action letters that earnouts are not debt securities requiring the qualification of an indenture

• 1940 Act
  – Some no action letters in particular circumstances
Contingent Payment Mechanisms in Public Deals

Dennis J. White
McDermott Will & Emery
Contingent Payment Mechanisms

- Two basic types:
  - Contingent Payment Rights (CPRs)
    - The right to receive an event-driven contingent payment which delivers value to the sellers upon a positive outcome of an uncertain situation.
  - Contingent Value Rights (CVRs)
    - The right to receive cash or securities in the event the post-closing price of the acquirer’s stock falls below a stipulated price.
Contingent Payment Rights
CPRs – An Overview

• CPRs are designed to allocate risk by delivering value to the Target’s stockholders there occurs on a post-closing basis a positive event (or if a negative event fails to occur) which was difficult to value at signing, but would significantly impact the value of the combined entity post-closing.
  – Litigation-outcome – Target’s stockholders to receive a portion of any recovery in pending litigation being pursued by the Target.
    • If the deal is priced to assume the Target will not prevail in its defense of a pending claim, a CPR could convey the message that the purchase price was discounted.
  – Regulatory approval (e.g., Target’s stockholders to receive an additional $3 per share in the event FDA approval of new drug is granted).
  – The parties can be creative in crafting a mechanism which monetizes the future value of various operational variables.
  – It is unclear whether a CPR would constitute stock under Delaware law, and therefore it may trigger appraisal rights where such rights would not otherwise be present.
CPRs as Registrable Securities

• As discussed above, the SEC has set forth, in a series of no-action letters, the factors that it considers in determining whether a CPR would be a security requiring registration under the 34 Act.

• CPRs are typically structured to either clearly avoid being characterized as a security under the Act or are registered and publicly traded.
  – However, in the acquisition of Information Resources by Symphony Technology and Tennenbaum Capital, a trust was established to receive the proceeds of the litigation. The declaration of trust governed the terms and conditions of the CPRs. The CPRs represented assignable and transferable undivided beneficial interests in the assets of the trust. The CPRs become publicly traded on the OTC bulletin board.
Contingent Value Rights
CVRs – An Overview

• Using stock as consideration presents two distinct risks which are dealt with through different mechanisms.
  – Pre-closing risks that fluctuation in the Acquirer’s stock price will affect either the value of the consideration received by the Target’s stockholders or the amount of dilution suffered by the Acquirer’s stockholders.
    • Allocation of these risks is addressed through floors, caps and collars on the price or exchange ratio.
  – Post-closing risk that the stock price of the Acquirer will not perform well, eroding the value of the consideration delivered to stockholders.
    • CVRs can be used to re-allocate this risk in an effort to guarantee a level of value to the Target’s stockholders.
CVRs – An Overview

• In the event the post-closing price of the Acquirer’s stock is below a reference price at the maturity date, the Target’s stockholders receive additional consideration in the form of cash or securities of the issuer.
  – The maturity date is typically set from one to three years after the closing of the transaction.
  – E.g., if the reference price is $40 per share and the closing price of the Acquirer’s stock on the maturity date is $28 per share, $12 per share (in the form of cash or securities) would be paid to the Target’s stockholders.
CVRs – An Overview

• CVRs are financially analogous to put options which are in the money when the Acquirer’s stock price falls below the reference price.
  – Due to the similarity to a put option, a CVR is a security under the Act and must be registered.
  – CVRs, like other derivative securities, are typically traded separately.
• A floor can be set on the post-closing price of the Acquirer’s stock, putting a limit on the amount of additional consideration that would be paid out at the maturity date
  – E.g., if the reference price is $40 per share, the floor is $30 per share and the closing price of the Acquirer’s stock on the maturity date is $28 per share, $10 per share (not $12) would be paid to the Target’s stockholders.
CVRs – An Overview

- Redemption rights can be included, which give the Acquirer the right to redeem the CVR for cash or stock at a fixed price after the passage of time.
- “Up and Out” features can be included, which provide that in the event the post-closing price of the Acquirer’s stock remains above the reference price for a designated measurement period (e.g. 30 consecutive trading days), the CVR terminates automatically with no payment to the Target’s stockholders.
Strategic Choice

- There is inherent asymmetry of information between the Acquirer’s management and the market with respect to beliefs on integration, synergies and future profitability of the combined entity.
  - Management and the market will not equally assess the value of the post-closing entity in the same way.

- An Acquirer which has a relatively high intrinsic value and is confident in its ability to successfully integrate the Target and deliver an exceptional return has an incentive and ability to overcome the information asymmetry.
  - An acquirer whose stock price accurately reflects its intrinsic value, and does not include a large “bubble” component, can use CVRs to distinguish its bid due to the relatively low probability that it will need to pay out (as much) on the CVR relative to the lower intrinsic value of competing bidders.
Strategic Choice

• CVRs allow Acquirers to limit excessively dilutive stock issuances at closing.
  – The Acquirer may be able to use a smaller exchange ratio given the price protection.
  – Use of a CVR may inspire sufficient market confidence due to the bullish signal that it
    conveys, such that downward pressure on the Acquirer’s stock price on the eve of closing is
    mitigated.

• Given the proven difficulty in successfully and quickly integrated acquired
  companies, Acquirers must be careful to set a reference price which signals
  confidence in the deal while still being realistic during the relatively short time
  horizon.
Tax Considerations

• Will a CVR (particularly one that is separately traded) be characterized as “boot” and adversely affect the tax-free status of a transaction?
• Will the payout of the CVR on the maturity date (particularly if it more than a year out) cause some portion of the value of the shares received to be treated as taxable interest income pursuant to Section 483 of the Internal Revenue Code?
• In the event the CVR holder sells a position of the Acquirer’s stock while the CVR is outstanding, must the holder’s tax basis be spread over the shares and the CVR?
EARNOUTS AND OTHER PURCHASE PRICE PROVISIONS: PRACTICAL APPROACHES

Leigh Walton
Bryan W. Metcalf
and
Angela Humphreys Hamilton

_Bass, Berry & Sims PLC_
_Nashville, Tennessee_

June 2004
This paper considers the various ways in which payment of the purchase price in an acquisition can be structured. Variations can occur in the types of consideration payable at the closing, and many acquisitions provide for a post-closing adjustment or true-up. Further, the acquisition may include an earnout payable over a considerable period of time after the closing. Each of these purchase price provisions significantly impacts the leverages of the parties, the tax and accounting treatment of the transaction, the securities laws ramifications of the acquisition and the relationship of the buyer and seller after the closing.

I. FORMS OF CONSIDERATION

A. In General

The purchase price in an acquisition is typically paid by cash, stock of the acquiring entity, installment notes, the assumption of indebtedness or some combination thereof. Factors that affect the way the purchase price is paid include:

- the buyer’s access to cash;
- the seller’s desire or willingness to invest in the buyer’s business;
- the seller’s desire for a tax-free transaction;
- the structure of the transaction as a stock purchase, merger or asset acquisition; and
- the buyer’s desire to extend payments through notes, creating a source to satisfy indemnification claims.
B. Cash Payment

Payment by cash is appealing in its simplicity and because (absent a holdback to secure post-closing claims) it will largely terminate the relationship between the buyer and the seller at the closing. A cash payment, however, will result in the seller realizing an immediate gain for tax purposes on the transaction.


Cash payment, when chosen, may be made by bank cashier’s check, certified check or wire transfer. The seller generally will insist on same day funds through a wire transfer.

C. Payment by Stock

In transactions in which equity securities are used as consideration, complex issues of valuation are presented. Further, the securities issued in the transaction must be registered under the Securities Act of 1933, as amended (the “Securities Act”), or an exemption from registration must be available.

1. Valuation Issues

Once the parties agree to use stock as consideration and a purchase price has been arrived at, the parties must value the stock to be transferred. They may agree that the stock is to be valued at the market price as of the moment of their agreement on the price, as of the date the acquisition agreement is signed, as of the closing date or at or during some other time period. If the stock is not registered under the Securities Act, or if the transfer of the stock is otherwise restricted, the seller may demand a discount from market price. If the buyer’s stock will be registered under the Securities Act, the Securities and Exchange Commission (“SEC”) will insist that the number of shares to be issued to the seller’s shareholders be clearly indicated in the proxy statement for the meeting at which the transaction is approved, or be ascertainable from external sources at that time.
To avoid the obvious risk posed by using a single day’s stock price in the valuation, the parties typically choose to use an average market price of the buyer’s stock over some specified period of time, for example, the 10 trading days immediately preceding the third business day prior to the closing. To protect against extreme fluctuations in price, the parties will likely place an upper and lower limit – a collar – on the range within which the stock price may vary for the purposes of valuation. The collar may be defined by either share price or shares issuable in the transaction: for example, no greater than 1,500,000 shares to be issued but no fewer than 1,350,000; or a share price of no greater than $55, but no less than $45. Although it is most common for both components of the collar to be present in a transaction, occasionally deals are structured having only one component, the upper limit or the lower limit, depending upon the bargaining power and strategic positioning of the parties.

In a stock purchase price formula using both a collar and an average closing price to value a listed security, the parties might agree to the following provision:

“The aggregate number of shares of Buyer Common Stock issuable to Seller shall equal that number of whole shares of Buyer Common Stock equal to the quotient of (a) $100,000,000, divided by (b) the average of the closing prices of Buyer Common Stock as reported on the New York Stock Exchange for the 10 trading days ending on the date that is three Business Days prior to the Closing Date (the “Average Price”); provided, however, if the Average Price is less than $45, the calculation shall be made as if the Average Price were $45, and if the Average Price is greater than $55, the calculation shall be made as if the Average Price were $55.”

The parties also may agree that there is a right to terminate the contract if the price extends beyond the collar limits. For example, the definitive agreement may provide that in the event the purchase price falls below the lower limit, the buyer may, but is not required to, provide additional consideration, in cash or stock, to bring the purchase price up to the lower limit. If the buyer is unwilling to provide such additional consideration, the seller may terminate the agreement if it is unwilling to accept the lower purchase price. In drafting provisions of this type, it is important to consider the notification requirements of the parties. Once it is determined that the lower limit of the collar will not be met, must the buyer first
notify the seller whether it is willing to provide additional consideration to increase the purchase price to the lower limit, or must the seller notify the buyer whether it will terminate the agreement if the purchase price is not increased to the lower limit? Such provisions should be clearly addressed in order to avoid uncertainties and will be subject to negotiation.

2. **Restrictions on Resale**

Securities issued in an acquisition (like any other type of securities issuance) must be registered under the Securities Act, or an exemption from registration must be available. Typically Form S-4 is used for registration (although the use of Form S-1, S-2 or S-3 may be mandated if no shareholder approval is required or if a majority shareholder of the seller has agreed to support the transaction, thus assuring shareholder approval).

If the seller agrees to accept unregistered securities, a private placement exemption through Section 4(2) or Regulation D under the Securities Act is the typical route to securities laws compliance. When the seller’s shareholders receive stock that is issued under an exemption, they must hold the stock until it can be sold publicly under Rule 144 (typically a minimum one year holding period), another exemption from registration is available or the stock is registered. Even if received in a registered transaction, securities held by affiliates of a seller prior to the acquisition will, pursuant to Rule 145, be subject to the resale limitations of Rule 144 (other than the holding period limitations).

The seller may demand registration rights that obligate the buyer to register the seller’s resale of the stock. This provision may be constructed as a “demand registration right,” whereby the seller may require the buyer to register the securities upon demand, or a “piggyback registration right,” whereby the securities are registered as an add-on to another registration statement being filed by the buyer. Faced with the prospective expense of filing a registration statement for the stock, the buyer may resist such a provision or may seek to limit it. The buyer may limit the number of registrations that will be effected, may place time limits on the rights or may require that a minimum number of shares from the seller’s shareholders be available for sale. The seller may insist that no other registration rights be granted that are on terms more favorable than those granted to the seller’s shareholders and that the buyer pay all expenses (to the extent allowable under NASD regulations) of the registration.
3. Shareholder Approval

Approval of the buyer’s shareholders may be required for the issuance of the buyer’s stock as consideration for the acquisition. Approval of the buyer’s shareholders is necessary when the stock issued in the transaction is in excess of the buyer’s authorized shares or, in some instances, when the buyer’s shares are listed on the New York Stock Exchange (“NYSE”), the American Stock Exchange (“AMEX”) or the Nasdaq National Market (“Nasdaq”). The requirements for shareholder approval vary, but generally approval is necessary for transactions in which the buyer is issuing (or in the case of AMEX, has the potential to issue) 20% or more of its outstanding common stock, or if the issuance will for some other reason impact control of the buyer. The NYSE, AMEX and Nasdaq each have specific rules in effect in this regard.

Of course, state law also may require that the buyer’s shareholders approve the transaction. For example, under Section 6.21(f) of the Model Business Corporation Act, action by the shareholders of the surviving corporation in a merger is required if, among other conditions, the voting power of shares that are issued and issuable as a result of the merger will comprise more than 20% of the voting power of the shares of the corporation that were outstanding immediately before the transaction.

It is important to monitor a fluctuating purchase price involving the issuance of stock to determine if approval of the buyer’s shareholders is required. Upon execution of a definitive agreement including a purchase price based upon a fluctuating per share price, it may be anticipated that the price will remain high enough that the number of shares of buyer stock to be issued at closing will not reach the threshold requiring shareholder approval. However, if the buyer’s stock price drops, assuming the number of shares to be issued at closing is not first capped by the lower limit of the collar, the number of shares of buyer stock to be issued at closing could reach the threshold requiring shareholder approval. If obtaining shareholder approval is a concern, one alternative may be to pay the balance of the purchase price in cash.

4. Tax Considerations

In order to minimize the tax consequences of a transaction, an all stock transaction typically is structured as a reverse triangular merger. That is, the acquiring entity will set up a merger subsidiary that merges into the target. If a combination of cash and stock is used, a reverse triangular merger typically will be tax-free if the stock constitutes at least 80% of the aggregate consideration for the transaction. Because the value of the stock
is determined on the closing date, parties intending their transactions to be
tax-free under these provisions should provide some adjustment
mechanism in the contract if market fluctuations cause the value of the
stock in the deal to dip below 80% of the aggregate consideration. If the
stock involved is less than 80% of the aggregate consideration, a forward
triangular merger often will afford partially tax-free treatment. That is, the
acquiring entity will set up a merger subsidiary and the target will merge
into the merger subsidiary. If the stock involved falls below 45% of the
aggregate consideration, the stock component of the transaction generally
will be taxable unless a complex structure is used. In any reorganization,
shareholders will pay tax on the lesser of their gain realized and the cash
received; thus, it may not be worthwhile to structure a tax-free transaction
with respect to the stock being issued if cash comprises a large portion of
the deal consideration.

D. Payment by Promissory Note

Use of promissory notes as consideration can be attractive for several reasons.
The buyer may wish to pay by note if it is cash-constrained or for some other
reason wishes to lower its original cash outlay. By retaining a portion of the
purchase price, the buyer retains leverage with the seller for payment of
indemnification claims. Payment by note may also be beneficial to the seller for
tax reasons.

1. Set-Off Rights

The buyer may desire to use non-negotiable installment notes as part of
the consideration to create a source against which indemnification claims
can be offset. Although the right of offset is automatic under most state
laws, the buyer’s counsel is well advised to clearly establish the right in
the promissory note.

2. Tax Benefits

If payment is made by note, the seller will generally report any gain from
the sale on the installment method under §453 of the Internal Revenue
Code of 1986, as amended. Reporting on the installment method permits
the seller to defer a portion of its tax liability until it receives installment
payments on the note. The note cannot be secured by cash or certain cash
equivalents. Furthermore, the seller must make interest payments to the
government on the deferred tax liability on installment obligations
generally to the extent they exceed $5,000,000 in the year they arose.
After much debate, in 2000 Congress repealed a statute making
installment sale treatment available for accrual and cash basis taxpayers.
3. **Security for Payment of the Notes**

The seller may wish to negotiate security for payment of the note accepted in the acquisition. The seller may demand a security interest in the buyer’s assets, a letter of credit or a guarantee by a third party. The seller also may accept a pledge of the target’s stock acquired by buyer.

If this last technique is used, the seller should negotiate protections to ensure that the business, if returned in the event of default, has not been stripped of all of its value by the buyer. Provisions to protect against such a possibility include stipulating a minimum level of working capital to be maintained until the note is paid, prohibiting the buyer from engaging in the target’s line of business except through the target, restrictions on the sale of certain assets, restrictions on dividends from the target to the buyer and requiring the business of the target to be maintained in a separate entity.

II. **HOLDBACKS OF PURCHASE PRICE IN ESCROW**

A. **Overview**

The buyer may demand a readily accessible pool of money to cover post-closing indemnification claims and other specified contingencies. One common way to provide such a pool of money is an escrow arrangement providing that a part of the purchase price be placed in escrow, usually with an independent escrow agent, for a specified period of time after the closing. With the elimination of pooling transactions, restrictions regarding the types of contingencies and number of shares (previously, no more than 10%) with respect to which an escrow may be established also will be eliminated.

B. **Benefits and Risks**

The escrow fund established will provide greater ease of recovery for the buyer in the event of indemnification claims, alleviating concerns about the seller’s ongoing solvency and potential problems in locating the seller’s assets for executing judgments. Buyers should be aware that the seller will likely propose that the escrow fund be the sole remedy for the buyer’s post-closing claims. Sellers should realize that the existence of the escrow fund significantly changes the leverages for the post-closing resolution of disputes.

C. **Tax Treatment**

Funds paid into escrow and later paid to the seller generally will be taxed under the installment method described in I.D.2. above. In most escrow situations, the tax on payments received from escrow will be based on the presumption that all
of the escrow amount will be paid to the Seller. Adjustments are made in the subsequent year if the seller receives less than the full amount.

III. PURCHASE PRICE ADJUSTMENTS

A. Overview

Purchase price adjustments (as opposed to earnouts) are appropriate when there is a fundamental agreement between the parties as to the value of the target, but when there is a substantial period of time between signing and closing of the acquisition. A target’s value is usually determined on the basis of the most recent financial information available at the time of pricing. A typical purpose of a purchase price adjustment provision is to reflect changes in the value of the target between the signing of the acquisition agreement and the closing date (perhaps a significant period of time if a Hart-Scott-Rodino filing or other regulatory approvals are required, if securities are to be registered or if shareholders’ approval must be sought). If a purchase price adjustment is not used, the earnings generated by the target between the signing and the closing typically accrue to the benefit of the buyer, since most acquisition agreements prohibit the seller from making distributions during this period. Losses would similarly be borne by the buyer absent a post-closing adjustment. A post-closing adjustment is not a substitute for a “material adverse change” closing condition, which allows the buyer to refuse to close if the target’s financial results have materially deteriorated.

A post-closing adjustment can be constructed in a variety of ways. It typically is designed to assure the buyer that the decisions it made at the time of pricing are validated by the closing date financial statements. Common post-closing adjustments compare working capital or net worth variances between the most recent financial statements available when the acquisition agreement is signed and the closing date financial statements. In a transaction with a post-closing adjustment, the closing is generally scheduled for a month-end (or, even better, a fiscal quarter-end) to avoid difficult cut-off issues.

B. Typical Mechanics

The buyer and its accountants typically will prepare the required closing date financial statements. If the post-closing adjustment is a balance sheet driven adjustment and if inventory is critical, the parties may provide for a physical count of the inventory as of the closing date in connection with the preparation of the balance sheet. Both parties should observe the inventory count. Within a specified time period after the closing, the buyer delivers the closing date financial statements to the seller, along with the buyer’s initial determination of the purchase price adjustment amount. The buyer may make an initial
post-closing payment at this point if, based on its calculations, it owes the seller money. The seller then has a specified period of time during which to review the closing date financial statements. The seller may accept the draft or inform the buyer of specific objections to it.

C. Additional Drafting Considerations

1. Amount Paid at Closing

In many transactions, the buyer pays the fixed amount of the purchase price at closing, not reflecting any purchase price adjustment. Another possibility is for the buyer to pay at closing the fixed amount plus or minus an estimate of the purchase price adjustment, as determined by the seller. In either case, one party will have to settle with the other when the closing date financial statements are finalized and the purchase price adjustment is calculated.

2. Dispute Resolution: Designation of Independent Accountants

Because it is not uncommon for disagreements to arise in the determination of the post-closing adjustment, the parties should agree upon a dispute resolution mechanism in the acquisition agreement. A common provision for dispute resolution is to designate a firm of independent accountants to review the closing date financial statements. These accountants may act as auditors or as arbitrators only. If the identity of the independent accountants is not stipulated by the parties, the parties should specify the procedure for their selection. One alternative is for each party to select an accounting firm and the two firms selected to then select a firm to serve as independent accountants. The cost of involving three accounting firms is a practical detriment to this solution.

The lawyers drafting the provision should state whether the independent accountants are to examine only the disputed line items, or whether they may review the entire closing financial statements. The Model Stock Purchase Agreement with Commentary, published in 1995 by the Committee on Negotiated Acquisitions, Section of Business Law of the American Bar Association (the “Committee”), provides for submission only of the “issues in dispute” to the independent accountants, effectively eliminating this uncertainty. Model Stock Purchase Agreement, § 2.6(a). Likewise, the Model Asset Purchase Agreement with Commentary, published in 2001 by the Committee, provides only for the submission of “issues remaining in dispute” after negotiations between the parties to the independent accountants. Model Asset Purchase Agreement, § 2.9(d).
To avoid the cost of third-party accountants’ fees on smaller issues, the parties may set financial limits on the issues that may be submitted to the third-party accountants for review. They may provide that they will split the amount in dispute or ignore those smaller issues.

In any event the dispute resolution provisions should clearly designate the party who is responsible for the payment of the expenses of the dispute resolution. Typically the costs are split, or the non-prevailing party is held responsible.

3. **Accounting Specifications**

The parties should be wary of merely stipulating that the adjustment amount will be determined in accordance with generally accepted accounting principles (“GAAP”) consistently applied with past practice. As is discussed in greater detail in Section IV regarding earnouts, GAAP embraces a wide range of acceptable accounting practices. GAAP is also constantly in flux, with FASB bulletins presenting new guidelines on an ongoing basis, such as the FASB’s recent adoption of SFAS No. 141 (see Section I.B.), which eliminates the pooling of interests method of accounting for business combinations, and SFAS No. 142 (see Section IV.C.4.b.), which eliminates the amortization of goodwill in lieu of an impairment test. Past practice, meanwhile, may be difficult to ascertain after the fact.

The parties may wish to identify important line items on the closing financial statements and stipulate in writing the method of valuation for those items. The items requiring attention will vary based on the formulation of the post-closing adjustment. Line items or issues frequently requiring attention include:

- revenue recognition policies;
- reserves for doubtful accounts;
- reserves for obsolete inventory;
- allocation of overhead among the seller and the target;
- deferred accounts; and
- treatment of closing expenses.

The buyer is well advised to conduct due diligence into the accounting practices of the seller prior to signing the acquisition agreement so that the parties can stipulate the treatment for contentious items. The parties may also describe “past practice” in writing. If such guidelines are specified, the parties should state that the guidelines control in the event they conflict with GAAP.
4. **Caps and Floors**

The purchase price adjustment provision may contain a provision for a “cap,” which is an upper limit on the adjustment amount that may be paid out by the buyer and a “floor” that limits the adjustment amount that may be refunded by the seller.

Some risks are inherent in employing caps and floors. Parties should consider whether the use of a cap or a floor will grossly disadvantage one party if no other contractual remedies are provided. Employment of a cap or a floor may give rise to a risk that the party thus constrained will turn instead to contractual remedies in “unwind” provisions, deferred payment provisions and indemnity provisions.

5. **Mechanisms to Ensure Payment of the Adjustment Amount**

The parties may place part of the purchase price in escrow to ensure expedited payment of the adjustment amount to the buyer. If a promissory note has been used to finance the sale, the parties may agree to increase or decrease, as appropriate, the payments under the note to reflect the results of the purchase price adjustment.

IV. **EARNOUTS**

A. **Overview**

An earnout provision makes a portion of the purchase price contingent upon the acquired company reaching certain milestones during a specified period after the closing. The benchmarks used are typically financial, such as net revenues, net income, a cash flow measure or earnings per share. Non-financial thresholds are appropriate in some circumstances.

Earnouts (as opposed to typical post-closing purchase price adjustments) are most often utilized when the buyer and seller cannot agree on the value of the target. They are particularly useful in dynamic or volatile industries, or when the buyer’s projections for the target are fundamentally more pessimistic than those of the seller. An earnout arrangement rewards the seller if its projections are accurate, while protecting the buyer from overpaying if they are not. Buyers can use earnouts as a source from which they can offset indemnification claims. An earnout also may be attractive to a buyer desiring to bridge a financing gap.

In situations in which the seller’s management will continue to run the target after the closing, an earnout arrangement may be used by the buyer to motivate management with performance incentives. If the earnout is used in this context,
however, the earnout may be characterized as compensation rather than payment for the business and there may be accounting implications for the buyer.

Earnouts are used in transactions large and small, involving acquisitions of private and, to a lesser extent, public companies. Earnout arrangements are most likely to be used when the target is private since market valuations assist in the valuation of the public target. If an earnout is used to compensate public company shareholders, logistical problems will ensue unless careful planning is employed. To facilitate payments, a paying agent should be employed to disburse payments when received by the buyer. As discussed below under “Regulation Issues for Earnout Rights” and to minimize logistical issues, typically earnout rights are structured so as to be non-transferable (except under the laws of descent and distribution).

B. Some Risks Associated with the Use of Earnout Provisions

If inappropriately drafted, an earnout can hinder a purchaser’s efforts to reorient or restructure the target, misappropriate future value to the wrong party or motivate the earnout’s recipients to focus on short-term goals that will maximize the earnout. Further, earnouts have great potential for engendering later disputes about the contingent payment. Disputes often arise when the seller suspects that the buyer is using different accounting techniques during the post-closing period to diminish the payout, or is artificially depressing revenues or earnings during the earnout period. The seller also fears that the buyer simply will not run the business successfully. Buyers face the risk that the payout formula will overcompensate the seller in some unforeseen way, due to other acquisitions or a change in the buyer’s post-acquisition business plan that essentially has nothing to do with the target. These fears, many legitimate, should cause counsel for the buyer and the seller to carefully craft the earnout provisions. The Model Asset Purchase Agreement with Commentary contains as an attachment a separate earnout agreement that provides drafting guidance. Since each earnout is unique, reliance on forms must be measured.

C. Drafting Issues

1. Setting the Earnout Thresholds; Types of Possible Thresholds

Earnout thresholds may be financial or non-financial in nature, or both. In choosing milestones, and in drafting the acquisition agreement, the parties should identify and deal with any post-closing contingencies that could potentially alter the target’s ability to meet the earnout thresholds.
a. **Financial Thresholds**

Common financial thresholds include the target’s net revenue; net income; cash flow; earnings before interest and taxes or “EBIT”; earnings before interest, taxes, depreciation and amortization or “EBITDA”; earnings per share; and net equity thresholds.

Revenue-based thresholds are often thought to be more attractive to sellers, since they will not be affected by operating expenses or acquisitions. The buyer’s post-closing accounting practices will likely have less impact on revenue than other items. Buyers are more likely to agree to a revenue–based benchmark if costs of goods sold and overhead have little variability. Generally, however, buyers oppose revenue-based thresholds because they provide no incentive to the earnout recipients to control expenses, and may provide an incentive to generate short-term sales that may prove to be unprofitable. Buyers generally favor net income thresholds on the ground that they are the best indicator of the target’s success.

Parties often use EBIT or EBITDA measures as milestones in order to allay sellers’ concerns about net income measures. EBIT and EBITDA reflect the cost of goods and services, selling expenses and general and administrative expenses, and thus are more difficult to manipulate. They are additionally desirable because they exclude interest, taxes, depreciation and amortization, which may vary based on the buyer’s capital structure or the way in which the acquisition is financed. Finally, for a transaction that is initially valued using a multiple of post-closing cash flow, the use of EBIT or EBITDA for the earnout is logical to determine what is in essence deferred purchase price.

Regardless of the financial threshold chosen, the parties should carefully analyze the potential of the earnout to distort the incentive for producing long-term, sustainable growth. For example, as noted above, a revenue target may tempt the earnout recipients to book unprofitable business. An earnout based on cash flow or income could incentivize the earnout recipient to slash expenses (e.g. marketing and advertising costs) to bolster short-term profitability at the expense of long-term growth.
b. Non-Financial Thresholds

Non-financial thresholds often are used in acquisitions of development-stage companies. These companies may be difficult to value, due in part to their high growth rates, and are particularly suited to the use of non-financial milestones. In some industries, non-financial milestones may be the best indicator of fair value. Non-financial milestones may also serve the purpose of giving operational focus to the target.

A non-financial threshold could be completion by the company of a core product or new product, inclusion of a favorable article in a publication that meets specific criteria or the receipt of a “best technology” or “best in show” award for the company’s technology or product. See Spencer G. Feldman, *The Use of Performance (Non Economic) Earn-outs in Computer Company Acquisitions*, INSIGHTS, August 1996.

2. The Formula for Calculating the Payment Amount

For financial thresholds, the parties may stipulate the flat amount of consideration to be paid if the milestone is met. More typically, the buyer will pay the seller a specified percentage of the amount by which the target’s performance surpasses the threshold. For example, the buyer may make an annual payment to the seller equal to a percentage by which the target’s EBITDA for the year exceeds the threshold EBITDA agreed to by the parties. The payment also may be adjusted so that any shortfall in EBITDA for a previous year will reduce the payment otherwise due for the current year. An often difficult negotiation ensues regarding whether payments are prorated if the benchmark is only partially achieved. This negotiation is sometimes settled by establishing a minimum hurdle before any payment will be made and providing a sliding scale or proration after that hurdle is achieved. For non-financial thresholds, the parties must agree upon an amount of cash consideration or a number of shares of stock that will be delivered for each milestone that is met. In any event, the payout is often capped at a specified amount.

Care must be taken to specify with particularity the source of the earnout – whether the benchmark is to be applied to a product line, the entire target, the division into which the target is absorbed or some other source.

Lenders will often consider the recipient of an earnout an equity holder and seek to subordinate the payment to the lender's unsecured obligations, including seeking to limit payments while the lender's debt is outstanding.
The seller will object strenuously to such a limitation, likely making its objection known early in the negotiation. On the other end of the spectrum, the seller may demand credit enhancement (for example a letter of credit) for the earnout. These negotiations will turn on the leverage of the parties and the financial position of the buyer.

3. **The Length of the Earnout Period**

Most earnout periods conclude after the expiration of a specified length of time – generally between two and five years after the closing. The appropriate length will be determined based on how long it will take to measure the projected value of the target or the period during which the buyer desires to incentivize the former owners. On occasion the earnout is payable upon the occurrence of a specific event, such as the sale of the target, a change in control of the buyer or the termination of the earnout recipient's employment. Because earnouts may affect the flexibility of the post-closing operation of the target, and few subsequent purchasers of a business will accept assets burdened by an earnout, it is usually advisable to the purchaser to have a buyout option for the earnout. Crafting the valuation of the earnout buyout is generally difficult. Often parties rely on a multiple of historic payments or an expert valuation of the target.

4. **Determination of Whether the Threshold Has Been Satisfied**

a. **Determination of the Earnout**

The seller should insist that the buyer maintain separate books and records for the target, division or other source of the earnout throughout the earnout period. The buyer should covenant that these financial records will be made available for review upon reasonable notice.

The buyer and its accountants typically will make the initial determination of whether the milestones have been reached. The seller then will review the calculations and challenge them if necessary. In certain situations, it may be appropriate to require that the results of the earnout period be audited.

b. **Accounting Issues**

For financial milestones, the parties should stipulate with as much detail as possible the accounting principles that will be used to calculate whether the thresholds have been met. As noted above, GAAP embraces a wide range of acceptable accounting practices, and is consistently in a state of flux. The ability to manipulate the
results of an earnout through adjustment to GAAP is often legitimately of great concern to the seller. Particular care in delineating the calculation principles should be used if the threshold is a non-GAAP financial measure, such as EBIT or EBITDA. The parties thus should incorporate into the acquisition agreement a description of the accounting principles to be employed. Listed below are specific accounting issues that may arise:

(1) **Consistency of Practice in Post-closing Accounting**

A problem may arise in the form of movement of revenue and expenses by the party in control of the target after closing. The lawyers drafting the earnout provision should address this possibility and stipulate that post-closing accounting in this regard should not vary from prior practice. Special care must be taken, however, if the target was fundamentally different in the hands of the seller than the way it will be treated by the buyer (e.g., if the seller was an S corporation or compensation expense of the target as a C corporation was artificially high). Diligence into the pre-sale accounting policies of the seller will clarify past practice and reveal any areas of potential dispute. The parties should specify that changes in GAAP promulgated by the FASB after closing should not affect the determination of the earnout.

(2) **Potential Exclusions in Calculating the Payout and Other Possible Adjustments**

- The seller should seek to exclude all transaction related expenses that are charged against the earnings upon which the earnout is calculated.

- When net income is used as the performance yardstick, parties almost always adjust for heightened depreciation caused by a write-up in assets obtained in the acquisition. Prior to the FASB’s adoption of SFAS No. 142, *Goodwill and Other Intangible Assets*, effective June 30, 2001, parties also almost always added back goodwill amortization in calculating an earnout based on net income. SFAS No. 142 eliminates the amortization of goodwill for calendar year companies for (a) goodwill acquired after June 30, 2001, and (b)
for goodwill existing on June 30, 2001, after December 31, 2001. Instead, SFAS No. 142 requires an annual impairment test based on a comparison of the fair value of each reporting unit that houses goodwill acquired to the carrying amount of the reporting unit’s assets, including goodwill. Parties should consider the impact of the annual impairment tests in determining the earnout with respect to a transaction.

- When net income, EBIT or EBITDA are used as the performance measures, the seller should ascertain what administrative or general overhead expenses the buyer will allocate to the target after closing and determine how those expenses will impact the post-closing figures. For example, the allocation of corporate headquarters’ expenses and services allocated among affiliates should be carefully considered.

- The seller will likely attempt to exclude executive compensation expense allocated to the target.

- The seller’s counsel also may argue that indebtedness resulting from the acquisition allotted to the target after closing should be excluded when calculating the earnout. If indebtedness is excluded, care should be taken to exclude expenses associated with financings and prepayment penalties. The exclusion that covers the initial acquisition indebtedness should also cover subsequent refinancings.

- The parties also may desire to exclude extraordinary gains and losses.

- Intercompany transactions between the target and the buyer or its affiliates also require adjustment to reflect the amounts that the target would have realized or paid if dealing with an independent third party on an arm’s length basis. If an intercompany charge from the parent (even if characterized as a management fee) is actually a distribution of profits, the payment should not be treated as an expense in the calculation of the earnout.

- While most exclusions from the earnout calculation are demanded by the seller, the purchaser should consider
whether exclusions are appropriate. In some situations it may be appropriate for synergies arising out of the combination to be excluded from the earnout. Particularly if the buyer intends to use the target as a platform for future acquisitions, revenue, income or cash flow from these acquisitions may need to be excluded in the earnout calculation.

(3) Payments Pursuant to Tax-sharing Agreements

In most situations the target, once acquired, will become a party to a tax-sharing agreement with the buyer’s taxpayer group, or become a part of the buyer’s consolidated tax reporting group. The seller’s counsel should assure that payments made by the target pursuant to the agreement or as a member of the group do not have unanticipated effects on the attainment of the earnout thresholds.

(4) Accounting Treatment of the Contingent Consideration when Linked with Future Employment

A difficult accounting issue arises in those transactions in which contingent consideration is linked with the continued employment of the seller’s management. In transactions in which the contingency is based on the future earnings of the seller and the management of the seller enters into employment contracts with the new entity, the question arises whether the substance of the additional payments is truly a payment for the seller or rather a salary expense in the form of bonuses based on production. The issue is particularly relevant to acquisitions of small businesses.

In 1995, the FASB’s Emerging Issues Task Force reached a consensus on this issue in EITF 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchased Business Combination*. The consensus opinion notes that the following factors should be considered when evaluating the propriety of accounting for contingent consideration based on earnings:

- reasons for contingent payment provisions;
- the formula for determining contingent considerations;
- treatment of the contingent payment for tax purposes;
The determination as to whether payment of contingent consideration represents purchase price or compensation is based on facts and circumstances. The EITF notes that if a contingent payment arrangement is automatically forfeited if employment terminates, a strong indicator exists that the arrangement is, in substance, compensation. The EITF goes on to note, however, that the absence of linkage between continued employment and payment of contingent consideration does not necessarily imply that the payment of a contingency represents purchase price. Another factor is the proportionality of the seller’s right to receive earnout payment compared to the seller’s ownership interest. If proportionality exists, the earnout is more likely to be characterized as a deferred payment. If proportionality is lacking, then the earnout is more likely to be compensatory in nature. See Kimberly Blanchard, *The Taxman Cometh*, BUSINESS LAW TODAY, May/June 1997, at 61.

It is important to note that an earnout must be treated consistently as to avoid re-characterization. “As a threshold manner, an earnout should be treated as compensatory only if the seller actually performs services for the buyer after the sale or gives an economically meaningful covenant not to compete.” Kimberly Blanchard, *The Taxman Cometh, supra*, at 60.

(5) Other Issues to be Considered

Other potential areas for variation that should be addressed include inventory valuation methods (LIFO versus FIFO, as well as the manner of treating inventory as obsolete), depreciation schedules, accounting for retirement and welfare benefits and reserves for bad debts. The parties should carefully consider whether there are matters of heightened concern or specific to the target's industry, often mandating that the parties specify the accounting methodology to be used.
5. Form of Payment of Earnout Obligation

Cash is often used as the earnout payment, but not infrequently the contingent consideration is stock. The use of cash may be a problem when the target is thriving and the buyer’s other businesses are performing poorly. On the other hand, the use of stock to satisfy the earnout may dilute the buyer’s earnings per share. Additionally, the use of stock raises various valuation, securities and tax issues. The purchaser may be required to specify the maximum number of shares that will be issued as part of the earnout arrangement for securities and tax reasons that are detailed below.

a. Valuation Issues

The parties to the acquisition agreement must determine the date as of which the stock used in the earnout will be valued, which will likely be at either the time of the closing or the time of issuance. If the time of the closing is selected, the buyer likely risks an increase in the acquisition price caused by a run-up in the stock price between closing and the issuance.

The seller runs the risk that the buyer will issue additional common stock during the earnout period that is priced lower than the market price or the per share value assigned in the acquisition. Counsel for the seller may suggest a provision designed to protect against dilution of the shares that are earned but have not yet been distributed.

b. Securities Issues

The stock that is issued in an earnout must, of course, be registered or exempt from registration. Affiliates of the target who receive stock and affiliates of the buyer must abide by the selling restrictions of Rules 145(d) and 144, respectively, of the Securities Act.

Practitioners should examine Rule 144(d)(3)(iii), under which the earnout stock may be deemed to have been acquired at the time of the transaction’s closing for purposes of calculating the holding periods of Rule 144 if the issuer or affiliate was then committed to issue the securities subject only to conditions other than the payment of further consideration for such securities. An agreement to remain employed or not to compete entered into in connection with a transaction, or services performed pursuant to such an agreement, are not deemed payment of further
consideration. *See also* Medeva PLC, 1993 SEC No-Act LEXIS 1145 (concluding that the holding period for shares issued as deferred consideration commenced on the date the target shareholders elected to receive payment in shares rather than cash).

Additionally, in connection with the listing of the buyer’s stock at the time of the acquisition, a securities exchange will likely require that the buyer specify a limit on the number of its shares to be issued as contingent consideration.

c. **Related Tax Questions**

If the acquisition is structured as a tax-free reorganization, the use of contingent consideration may cause difficulties for the parties. In all types of tax-free reorganizations, there are limits on the amount of cash or other property (other than stock) that can pass as consideration. The permissible amounts vary by transaction form. Care must be taken to limit cash earnout payments to that allowed under the applicable reorganization type or to pay the earnout in additional stock that meets the applicable requirements.

Similar to escrow payments, amounts paid to the seller in years following the year of sale generally will be taxed on the installment method described in I.D.2. above. The specific treatment will depend on whether there is a stated maximum earnout amount or simply a period over which the earnout payments will be made.

With respect to otherwise tax-free transactions, the Original Issue Discount Rules of Section 483 of the Internal Revenue Code require that some portion of the deferred consideration, if made in stock, must be allocated to interest, reportable as such by the seller and deductible as such by the buyer. The remaining portion of the stock is generally treated as additional tax-free consideration emanating from the original purchase. The IRS has issued ruling guidelines relating to the treatment of this contingent stock in Rev. Proc. 84-42, 1984-1 C.B. 52.

6. **Operation of the Acquired Business During the Earnout Period**

Both the buyer and the seller may fear mismanagement during the earnout period that could affect the payout.
a. **Operation by the Buyer Post-closing**

The seller typically has concerns that the target will not be properly managed after the closing. In situations in which the seller’s management team will not be retained post-closing, the seller likely will require that the buyer operate the target in the ordinary course of business consistent with past practice, and will attempt to reserve, through contractual covenants, some authority regarding major decisions made during the earnout period. The seller will likely demand that the target be operated as a distinct business entity or division so that its results can be verified. The seller may require that the buyer adequately fund the target during the earnout period so that it will be able to capitalize on opportunities presented to it. It is not uncommon for the seller to establish minimum absolute funding levels. The earnout may be crafted to acknowledge the parties’ agreement or intent to exploit specified opportunities. Any limitation of the buyer’s freedom to run the target as circumstances require likely will be resisted.

b. **Operation by the Seller’s Management Team Post-closing**

Less commonly, the seller’s management will continue to operate the target post-closing. In this situation, the buyer’s risk is that the seller’s management team will operate the business so as to unfairly maximize the payout amount. Counsel for the buyer should attempt to provide appropriate controls over the target, including a mechanism for reviewing decisions that can affect the payout.

c. **Protection Placed in the Acquisition Agreement**

The parties also may wish to include detailed post-closing operational procedures in the acquisition agreement in order to avoid uncertainty. For example, the buyer might covenant to operate the company consistent with past practice subject to certain exceptions, or the buyer might agree to restrictive covenants that prevent the target from taking specified actions (such as making large expenditures) during the earnout period.

In *Horizon Holdings, LLC v. Genmar Holdings, Inc.*, 244 F. Supp. 2d 1250, 1257-58 (D. Kan. 2003), the court held that when evaluating the principles of good faith and fair dealing, a court may imply terms to honor the parties reasonable expectations. In *Horizon*, the seller had remained on staff as president of the new
entity in an attempt to realize the $5.2 million earnout. The earnout was defined in the agreement as part of the purchase price. The seller had been assured that he would be given autonomy as president and that he had a realistic opportunity to receive the earnout. However, upon acquiring Horizon, the buyer interfered with business operations and prevented the seller from meeting the earnout threshold. In sweeping language, the court held that it could imply terms in an agreement to honor the parties reasonable expectations when those obligations were omitted from the text of the contract. In determining whether to imply terms in an agreement, the court noted that the proper focus was on “what the parties likely would have done if they had considered the issue involved.” The court stated that the jury could have readily concluded that the parties would have agreed, had they thought about it, that the buyer would not be permitted to undermine the president’s authority, to abandon the company’s brand name, or to mandate production of a rival product thereby impairing the realization of the earnout. The jury award of $2.5 million was upheld.

A key lesson to be learned from the Horizon Holdings case is that the parties should be explicit in crafting the expectations for the post-closing conduct of the parties to circumvent a court setting the ground rules.

In another recent earnout case, Richmond v. Peters, et al., 155 F.3d 1215 (6th Cir. 1998), plaintiff sold his business to defendant with the price and payments to be determined, in substantial part, by reference to the profits of the continuing business in excess of a base-level amount. The agreement between them provided that the business was to be managed in accordance with “sound business practices.”

Plaintiff claimed that defendant breached their agreement and further breached a fiduciary duty owed by defendant to the seller. On motion for judgment as a matter of law after plaintiff presented its case, the trial court ruled that Ohio law imposed no fiduciary duty upon defendant and that plaintiff had presented no evidence that defendant had breached any provision of the agreement.

The court held that the facts of the case should be reviewed with respect to the contract claim. It is significant, however, that the trial court found, and the appellate court agreed that, at least under
Ohio law, the earnout agreement created no implied fiduciary duty between the parties.

7. Payment of Earnouts to Public Shareholders

Payment of earnouts to public shareholders of a seller that does not survive the transaction can be a logistical problem. One common solution is to establish a paying agent to disburse earnout payments to the seller’s former shareholders. This paying agent may handle any disputes with the buyer during the earnout period as well.

8. Shareholders Designated to Act for the Seller

In situations in which the entire seller is sold to a buyer in a transaction with an earnout, the parties should consider establishing a committee to act on behalf of the persons who were shareholders of the seller at the closing. The committee would speak for the shareholders on matters relating to the earnout and indemnification. The provisions establishing the committee should delineate its powers and how it can act. Funds should be set aside to cover the expenses of the committee and its counsel. Often, the acquisition agreement simply will specify that the buyer will communicate with the committee, or shareholders’ representative, post-closing. In such case, the obligations of the committee to the shareholders will be addressed in a separate shareholders’ representative agreement.

9. Sale of the Target During the Earnout Period

The parties should determine whether the target or a portion thereof may be sold to a third party during the earnout period, and the effect of such a sale should it take place. A similar problem arises when a third party acquires the buyer during the earnout period. As suggested above, the lawyers for the seller may suggest that the third party buyer be obligated to pay off some or all of the earnout amount at the time of the second sale.

10. Integration of the Target into the Buyer’s Other Businesses

The parties must decide how to calculate the earnout if the target should be merged into similar entities owned by the buyer. The difficulty of measuring performance in this case may make buyers reluctant to fully integrate the acquired business into the rest of the buyer’s business. A parallel difficulty arises when the buyer acquires additional, similar businesses during the earnout period. In these situations, the buyer and seller must work with accountants to formulate a plan for segregating the financial statements that form the basis of the target’s earnout thresholds. This segregation can preclude the buyer from achieving the economies of
scale and synergies it anticipated in consummating the acquisitions. One solution is to assess the financial performance of the whole group and, for purposes of calculating the earnout, assign to the target its pro rata share of the overall amount. Alternatively, some buyers pay off the sellers during the earnout period to end the arrangement early.

11. **Averaging Periods of Strong Performance With Weak Performance**

The parties must decide whether performance well above threshold levels in one part of the earnout period may be applied to supplement a lesser performance during another part of the earnout period.

12. **Dispute Resolution**

Disputes regarding earnouts are commonplace, and the lawyers drafting the earnout provision are well advised to consider the appropriate form of dispute resolution under the circumstances. Many earnouts require binding arbitration of disagreements that the parties cannot resolve within a brief period of time. Arbitration is favored over litigation because the former generally is faster, less expensive and a better forum within which to deal with complex financial issues. However, the growing perception that arbitrators render “split the baby” decisions that attempt to satisfy both sides has caused some advisors to favor litigation as a more predictable source of appropriate outcome. If litigation is favored, jurisdiction and venue should be specified. All provisions regarding dispute resolution should be detailed and carefully crafted anticipating all plausible scenarios.

13. **Registration Issues for Earnout Rights**

Under certain circumstances earnout rights may be deemed securities under the Securities Act. To prevent the necessity of registration, acquisition agreements usually prohibit any transfer of the right to the earnout payment and assert that the right is not an investment contract or other type of security.

In a series of no-action letters, the SEC evaluated whether or not specific earnout agreements constitute a security.\(^1\) The SEC emphasized that the facts of any particular situation must be evaluated closely, but it

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concentrated on the following factors when deciding that a particular earnout did not constitute a security:

- The earnout right was granted to the sellers as part of the consideration for the sale of their business and neither the purchasers nor the sellers viewed the right as involving an “investment” by the sellers;
- The earnout right did not represent an ownership interest in the purchaser and was not evidenced by any certificates;
- The earnout right could not be transferred except by operation of law; and
- The earnout right did not entitle the owner to voting or dividend rights.

14. Special Industry Limitations

Advisors to parties desiring to structure an earnout are cautioned to ascertain the legality of the arrangement under the regulatory laws applicable to the transaction. For example, under the federal self-referral statute (commonly known as “Stark”) a hospital may not pay for a physician practice it acquires in installments or through an earnout (assuming the physicians will refer to the hospital after the transaction). The prohibition’s rationale is to eliminate a physician’s motivation to refer to the hospital, thereby enhancing the financial strength of the hospital so it can pay the earnout. Other industry-specific requirements may affect the ability to structure acquisitions with earnouts.

V. CONCLUSION

There are many forms of consideration paid in acquisitions, all with their own advantages and disadvantages. The most common forms of payment are cash, stocks, promissory notes, the assumption of indebtedness or some combination thereof. The parties should pay close attention to the accounting, tax, securities laws and practical consequences of each form of consideration. Importantly, the chosen form of consideration may affect the leverage between the parties after the closing.

In many transactions, some form of purchase price adjustment is appropriate. Even when there is fundamental agreement between the parties as to the purchase price, if there is lag time between the pricing and closing, some form of “true-up” may be appropriate.
Earnouts are usually employed when there is a disagreement as to the value of the target, but may also be useful in other scenarios such as a performance incentive. Parties should take great care in crafting the earnout. They should specify, in detail, the nature of the hurdle giving rise to the earnout obligation, the accounting methods that will be used in ascertaining whether the earnout has been achieved, the inclusions and exclusions from the earnout calculation and who will determine whether the earnout threshold had been met. It is essential that all possible scenarios be explored as the earnout is crafted to avoid future conflict.
Leigh Walton joined Bass, Berry & Sims PLC in May of 1979, and was named a Member of the firm in 1984. Ms. Walton concentrates her practice in corporate, securities and health law matters. Her work with public companies includes securities offerings, mergers and acquisitions, joint ventures and corporate governance. She has also represented numerous early stage healthcare businesses in connection with securing venture capital financing.

Ms. Walton's representative transactions include the following.

- Represented IASIS Healthcare Corporation in its $1.4 billion sale to Texas Pacific Group.

- Represented Spheris, Inc. in its $64 million acquisition of EdiX from IDX Systems Corporation.

- Represented Landair Corporation (market capitalization $88 million) in its going private transaction effected as a tender offer.

- Represented Children's Comprehensive Services, Inc. in its merger into Kids Holdings, Inc. for approximately $70 million.

- Represented Ingram Entertainment Inc. in its acquisition of Major Video for approximately $43 million.

- Represented HCA Inc. in its joint ventures with Quorum Health Group, Inc. including multiple hospitals in Macon, Georgia, and Vicksburg, Mississippi. Approximate size of transaction was $235 million.

- Represented Forward Air Corporation in the tax-free spin-off of Landair Corporation (companies with market capitalizations of $255 million).
• Represented HCA Inc. in the sale of hospital assets in Baton Rouge, Louisiana, to Quorum Health Group, Inc. in a transaction with consideration of approximately $32 million.

• Represented Ingram Industries Inc. in the spin-off of Ingram Micro Inc. and Ingram Entertainment Inc.

Ms. Walton is active in the American, Tennessee and Nashville Bar Associations, serving as vice chair of the ABA’s Committee on Negotiated Acquisitions and as a member of the ABA's Corporate Laws and Corporate Practice Committees. She serves as co-chair of ALI-ABA's Representing the Growing Business: Tax, Corporate, Securities and Accounting Issues and as a co-chair of PLI's annual program Nuts and Bolts of Securities Laws. She lectures annually at the ABA's Annual Mergers and Acquisitions Institute and participates from time to time in many other seminars and programs on corporate, securities and health law matters. Ms. Walton served as co-chair of the Tennessee Corporate Law Revision Committee which drafted the Tennessee Business Corporation Act. She was a lecturer at Vanderbilt University Law School from 1980-1987. She is also a member of the American Health Lawyers Association and a Fellow of the Tennessee Bar Foundation. She is a current member of the Metropolitan Development and Housing Agency of Metropolitan Davidson County and is the 2004 campaign chair for the Legal Aid Society of Middle Tennessee and the Cumberlands.

Ms. Walton is one of only two Tennessee attorneys named in The International Who's Who of Corporate Governance Lawyers in 2004. She is also listed in The Best Lawyers in America®, in Nashville Business Journal’s top Healthcare 100, and appears in the Nashville Post’s list of Best Lawyers in Nashville for 2003. She has also been named one of America’s Leading Business Lawyers by Chambers USA.

Ms. Walton received a B.A. degree, magna cum laude, from Randolph-Macon Woman's College in Lynchburg, Virginia, and her J.D. from Vanderbilt University Law School, where she was a member of Order of the Coif and the National Moot Court Team.
Mr. Metcalf is a Member in the firm's Tax Practice Area. He graduated from Furman University (B.A. (Accounting), magna cum laude 1992), The University of Michigan Law School (magna cum laude 1995) and New York University School of Law (LLM (Taxation) 1996). While at the University of Michigan, Mr. Metcalf served as an associate editor of the Michigan Law Review. At New York University, he served as a graduate editor of the Tax Law Review. He joined Bass, Berry & Sims in 1996 and has practiced exclusively in the tax section of the firm with a broad range of experience in corporate and partnership taxation, state and local taxation and estate and gift taxation. He has written and spoken frequently on tax related issues. His tax and litigation experience includes the following:

- Representation of several public corporation clients in the planning and implementation of major corporate restructuring (including the spin-off transactions for American Healthcorp, Inc., Landair Corporation and Envoy Corporation)

- Representation of a number of the contractors at the Arnold Engineering Development Center in connection with a variety of state and local tax issues.

Angela Humphreys Hamilton is an associate in the Nashville office and is a member of the Corporate and Securities and Healthcare Practice Areas. Her practice includes the representation of public and private companies, particularly healthcare companies, in mergers, acquisitions, joint ventures and related transactions. She also counsels clients on various corporate, governance and public company disclosure matters.

A native of Limestone, Tennessee, Ms. Hamilton graduated from the University of Tennessee summa cum laude with a B.S. in Accounting in 1991. She graduated from the University of Tennessee College of Law and received her J.D. summa cum laude, as the College of Law’s top graduate, in 1996. She was the recipient of the College of Law’s 1996 Outstanding Graduate Award and was elected to the Order of the Coif. She also served as research editor for the Tennessee Law Review and was the recipient of the Tennessee Law Review Editing Award. Ms. Hamilton is a certified public accountant. She is a member of the American, Tennessee and Nashville Bar Associations, Tennessee Society of Certified Public Accountants and American Health Lawyers Association.
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Following jury verdict for acquired aluminum boat manufacturing company, its founder and president, and his daughter and son-in-law, who occupied management roles in company, on their claims that acquiring company and its representatives breached purchase agreement and employment agreements, the plaintiffs moved to alter and amend judgment and for attorney fees, and acquiring company moved for judgment as matter of law (JMOL) or remittitur and/or new trial. The District Court, Lungstrom, J., held that: (1) finding that acquiring company breached implied covenant of good faith and fair dealing was supported by evidence; (2) damages award of $2.5 million for lost earn-out to acquired company and president was not speculative, was supported by evidence, was not excessive, and thus award would not be remitted; (3) issues of whether daughter and son-in-law were terminated consistent with terms of employment agreement, and whether agreement guaranteed employees any specific term of employment, were for jury on employees' contract claims; (4) damages award to daughter and son-in-law were not excessive, and thus would not be remitted; (5) parol evidence concerning what the parties discussed prior to executing purchase agreement, to extent such evidence did not contradict agreement, was admissible; (6) acquired company and president waived right to assert that contractually agreed on two percent per month post-judgment interest rate applied to contract claim by failing to include assertion in pretrial order; and (7) request for nearly $850,000 in attorney fees by acquired company and president was reasonable.

Motions granted in part, and denied in part.

[1] Federal Civil Procedure 2608.1
170Ak2608.1 Most Cited Cases
Motion for judgment as a matter of law (JMOL) after trial should be cautiously and sparingly granted, and is appropriate only if evidence, viewed in light most favorable to the nonmoving party, points but one way and is susceptible to no reasonable inferences supporting the party opposing motion. Fed.Rules Civ.Proc.Rule 50(b), 28 U.S.C.A.

170Ak2609 Most Cited Cases
In determining whether judgment as a matter of law (JMOL) after trial is proper, district court may not weigh evidence, consider credibility of witnesses, or substitute its judgment for that of the jury. Fed.Rules Civ.Proc.Rule 50(b), 28 U.S.C.A.

170Ak2608.1 Most Cited Cases
In determining motion for judgment as matter of law (JMOL) after trial, district court must affirm jury verdict if, viewing record in light most favorable to the nonmoving party, it contains evidence upon which the jury could properly return a verdict for the nonmoving party, but court must enter JMOL in favor of the moving party if there is no legally sufficient evidentiary basis with respect to claim or defense under controlling law. Fed.Rules Civ.Proc.Rule 50(b), 28 U.S.C.A.

[4] Sales 383
343k383 Most Cited Cases
Jury's finding that acquiring company and its representatives breached, under Delaware law, implied covenant of good faith and fair dealing in purchase agreement with acquired aluminum boat manufacturing company was supported by evidence that representatives engaged in conduct that detrimentally impacted on ability of acquired company to realize earn-out consideration, which was defined in purchase agreement as part of purchase price, and that representatives acted in bad faith with dishonest purpose or furtive design.
Under Delaware law, principles of good faith and fair dealing permit court to imply certain terms in agreement, so as to honor the parties' reasonable expectations, when those obligations were omitted, in literal sense, from text of written agreement but can be understood from text of agreement, and in deciding whether to imply terms in agreement, proper focus is on what the parties likely would have done if they had considered issue involved.

Under Delaware law, violation of implied covenant of good faith and fair dealing implicitly indicates bad faith conduct.

To establish that acquiring company acted with bad faith conduct towards acquired company and its president, as required for breach of implied duty of good faith and fair dealing claim under Delaware law, it was not necessary to show some furtive design or ill will on part of company.

Jury's award of $2.5 million in damages in form of lost earn-out, which was not equivalent of lost profits, to acquired company, based on acquiring company's breach of implied covenant of good faith and fair dealing in purchase agreement, was not speculative and was supported by evidence that acquired company would have been profitable and that earn-out consideration in agreement would have been obtainable if acquiring company's representatives had performed in good faith their obligations under purchase agreement.

Under Delaware law, any doubt concerning amount of damages sustained by plaintiffs for defendant's breach of implied covenant of good faith and fair dealing in contract is resolved against defendants, the breaching party. Restatement (Second) of Contracts § 352 comment.

Under Delaware law, court may order remittitur only if verdict is so grossly out of proportion as to shock court's conscience.

Under Delaware law, court may order remittitur only if evidence preponderates so heavily against jury verdict that reasonable jury could not have reached result.

Issues of whether employees were terminated for lack of adequate job performance consistent with terms of employment agreement or whether employment agreement guaranteed employees any specific term of employment were for jury in employees' breach of contract action.

Damages award of $ 52,000 in lost wages and $ 11,000 in lost bonus earnings to terminated employee, based on determinations that employer breached employment agreement and that employee would have earned bonus absent employer's conduct, was not excessive, and did not shock the conscience, so as to warrant remittitur.

In action alleging that employer breached
employment agreement, burden was on employer to prove that employee failed to mitigate her damages.

[16] Labor and Employment 867
231Hk867 Most Cited Cases
(Formerly 255k41(1) Master and Servant)

Damages award of $20,313 to employee in lost bonus earnings, based on determinations that employer breached employment agreement and that employee would have earned bonus absent employer's conduct, was not excessive, and did not shock the conscience, so as to warrant remittitur.

[17] Evidence 434(11)
157k434(11) Most Cited Cases

Parol evidence of negotiations between acquired aluminum boat manufacturing company and acquiring company was admissible in contract action to support claim of acquired company and its president that they were fraudulently induced into executing purchase agreement.

[18] Federal Civil Procedure 2334
170Ak2334 Most Cited Cases

Where acquiring company failed to raise timely objection to admission of parol evidence regarding negotiations with acquired aluminum boat manufacturing company on basis that such evidence was inadmissible with respect to claim that acquiring company breached implied duty of good faith and fair dealing in purchase agreement, and failed to request limiting instruction, district court reviewed admission of evidence under "plain error" standard.

170Ak2334 Most Cited Cases

Admission of evidence concerning negotiations between acquired aluminum boat manufacturing company and acquiring company, which occurred prior to execution of the parties' purchase agreement, at trial with respect to claim that acquiring company breached its implied duty of good faith and fair dealing was not plain error, absent showing that evidence concerning the parties' negotiations varied or contradicted terms of purchase agreement, so as to require invocation of parol evidence rule.

[20] Evidence 427
157k427 Most Cited Cases

Parol evidence concerning what acquiring company and acquired aluminum boat manufacturing company discussed prior to executing purchase agreement, to extent such evidence did not contradict agreement, was entirely relevant to issue of whether defendants breached covenant of good faith and fair dealing, since the parties' reasonable expectations at time of contract formation determine reasonableness of challenged conduct, and thus evidence was admissible.

[21] Evidence 397(1)
157k397(1) Most Cited Cases

Parol evidence rule requires district court to exclude extraneous evidence that varies or contradicts terms of unified written instrument.

[22] Contracts 312(1)
95k312(1) Most Cited Cases

[22] Labor and Employment 842
231Hk842 Most Cited Cases
(Formerly 255k30(1.15) Master and Servant)

Under Delaware law, requirement that a party prove fraudulent conduct to demonstrate violation of implied duty of good faith and fair dealing was limited to employment-at-will context, and did not apply in commercial context.

[23] Contracts 168
95k168 Most Cited Cases

Delaware law imposes duty of good faith and fair dealing in every contract.

[24] Contracts 168
95k168 Most Cited Cases

Duty of good faith and fair dealing, under Delaware law, includes requirement that a party avoid hindering or preventing the other party's performance.

[25] Contracts 168
95k168 Most Cited Cases

Under Delaware law, implied covenant of good faith and fair dealing emphasizes faithfulness to agreed common purpose and consistency for justified expectations of the other party.

[26] Interest 34
219k34 Most Cited Cases
Despite mandatory language in federal statute governing post-judgment interest, the parties in contract dispute could agree to post-judgment interest rate other than standard one contained in statute; statute was intended to be mandatory in sense that district court or other third party, e.g., an arbitrator, had no discretion to award different rate of interest or to decline to award post-judgment interest, but it was not intended to prevent parties themselves from agreeing to different rate. 28 U.S.C.A. § 1961(a).

[27] Federal Civil Procedure 170Ak2737.5
170Ak2737.5 Most Cited Cases

Acquired company and its president, who prevailed in contract dispute with acquiring company, waived right to assert that two percent per month post-judgment interest rate contained in the parties' agreement applied by failing to include assertion in pretrial order, but plaintiffs could still recover post-judgment interest at rate specified in federal interest statute; acquiring company was entitled to notice that plaintiffs intended to seek postjudgment interest at the contractual rate prior to trial so that it could have raised any factual defenses to request to jury and adequately assessed risks of trial. 28 U.S.C.A. § 1961(a).

[28] Federal Civil Procedure 170Ak2738.1
170Ak2738.1 Most Cited Cases

Prevailing plaintiffs are entitled to post-judgment interest on damages award, at least at rate established in federal interest statute, despite their failure to request such award in pretrial order. 28 U.S.C.A. § 1961(a).

[29] Federal Civil Procedure 170Ak2655
170Ak2655 Most Cited Cases

Motion to alter and amend judgment cannot be used to raise new issue that could have been raised prior to judgment. Fed.Rules Civ.Proc.Rule 59(e), 28 U.S.C.A.

170Ak2737.14 Most Cited Cases

Where plaintiffs' attorney fee request stems from contractual fee provision, plaintiffs' request is subject to far less scrutiny than request made pursuant to fee-shifting statute and district court does not possess same degree of equitable discretion to deny such fees as it has when applying statute providing for discretionary award.

[31] Federal Civil Procedure 2737.5
170Ak2737.5 Most Cited Cases

Requested hours in application for attorney fees by acquired company and its president, who prevailed on contract claim against acquiring company and its representatives, were reasonable.

170Ak2742.5 Most Cited Cases

To meet their burden of proving number of hours reasonably spent on litigation, prevailing plaintiffs seeking attorney fees must submit meticulous, contemporaneous time records that reveal, for each lawyer for whom fees are sought, all hours for which compensation is requested and how those hours were allotted to specific tasks.

[33] Federal Civil Procedure 2742.5
170Ak2742.5 Most Cited Cases

In assessing appropriate attorney fees award, district court may reduce number of requested hours when time records provided to court are inadequate.

[34] Federal Civil Procedure 2742.5
170Ak2742.5 Most Cited Cases

In analyzing prevailing plaintiffs' request for attorney fees, district court is not obligated to comb record to ferret out deficiencies in plaintiffs' submission; rather it is defendants' obligation to direct court to such deficiencies if they believe such deficiencies exist.

[35] Federal Civil Procedure 2737.5
170Ak2737.5 Most Cited Cases

Request by acquired company and its president, who prevailed on contract claim against acquiring company, for nearly $850,000 in attorney fees would not be reduced due to plaintiffs' alleged limited success at trial; verdict for plaintiffs of $2.5 million was substantial victory for plaintiffs, and contract claim, which encompassed breach of implied duty of good faith and fair dealing claim, was not simple claim.

[36] Federal Civil Procedure 2737.5
170Ak2737.5 Most Cited Cases

Attorney fee award to acquired company and its president, who prevailed on their contract claim...
against acquiring company and its representatives, would not be reduced to exclude time spent on unsuccessful claims, which were intertwined with successful contract claim through common core of fact or related legal theories.

[37] Federal Civil Procedure 2737.4

When lawsuit consists of related claims, plaintiff who has won substantial relief should not have his attorney's fee reduced simply because district court or jury did not adopt each contention raised.

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MEMORANDUM & ORDER

LUNGSTRUM, District Judge.

**1 Plaintiffs filed suit against defendants asserting various claims arising out of defendants' acquisition of plaintiff Horizon Marine LC, an aluminum boat manufacturing company. Specifically, plaintiffs Horizon Holdings, LLC f/k/a Horizon Marine LC (hereinafter "Horizon") and Geoffrey Pepper claimed that defendants breached both the express terms of the purchase agreement entered into between the parties and the duty of good faith and fair dealing implied in the purchase agreement. Plaintiffs Horizon and Mr. Pepper further claimed that defendants made a variety of fraudulent misrepresentations to them for the purpose of inducing plaintiffs to enter into the purchase agreement. In addition, plaintiffs Cassandra O'Tool and John O'Tool alleged that defendants breached the employment agreements signed by them. Ms. O'Tool further alleged that defendants discriminated against her on the basis of her pregnancy when they denied her a raise and when they terminated her employment. Finally, Ms. O'Tool and Mr. Pepper claimed that defendants unlawfully terminated their employment in retaliation for Ms. O'Tool's and Mr. Pepper's complaints of pregnancy discrimination. For a more thorough understanding of the facts of this case, please see the court's order resolving defendants' motions for summary judgment, Horizon Holdings, LLC v. Genmar Holdings, Inc., 241 F.Supp.2d 1123 (D.Kan.2002).

In November 2002, plaintiffs' claims were tried to a jury and, at the conclusion of the trial, the jury returned a verdict in favor of plaintiffs Horizon and Mr. Pepper on their breach of contract claim in the amount of $2,500,000. The jury also found in favor of the O'Tools on their claims that defendants breached the O'Tools' employment contracts and awarded Ms. O'Tool the sum of $63,200 and Mr. O'Tool the sum of $20,313. The jury found in favor of defendants on all other claims.

This matter is presently before the court on three post-trial motions- plaintiffs' motion to alter or amend the judgment (doc. # 197); plaintiffs' motion for attorneys' fees, costs and expenses (doc. # 198); and defendants' renewed motion for judgment as a matter of law pursuant to Rule 50(b) or, in the alternative, motion for remittitur *1256 and/or new trial pursuant to Rule 59 (doc. # 199). As set forth in more detail below, plaintiffs' motion to alter or amend the judgment is granted only to the extent that a typographical error in the judgment will be corrected and is otherwise denied; plaintiffs' motion for attorneys' fees, costs and expenses is granted in part and denied in part; and defendants' renewed motion for judgment as a matter of law, for remittitur and/or for a new trial is denied.

I. Defendants' Renewed Motion for Judgment as a Matter of Law, for Remittitur and/or for New Trial

Defendants seek post-trial relief on all aspects of the jury's verdict that are favorable to plaintiffs. The primary thrust of defendants' post-trial motion concerns the jury's verdict of $2.5 million in favor of Horizon and Mr. Pepper on the breach of contract claim. According to defendants, this award constitutes a windfall unsupported by the facts or the law. Defendants urge that plaintiffs, as a matter of law, are not entitled to recover any damages in the form of lost earn-out. In the alternative, defendants contend that the award must be remitted or a new trial must be granted on lost earn-out damages. Defendants also seek judgment as a matter of law on the jury's liability finding on the breach of contract claim, asserting that plaintiffs failed to present legally sufficient evidence that defendants breached the express or implied terms of the purchase agreement.
Similarly, defendants move for judgment as a matter of law on the O'Tools' claims for breach of their respective employment agreements or for a remittitur of those verdicts. Finally, defendants assert that they are entitled to a new trial because the court erroneously admitted parol evidence and erroneously instructed the jury on the duty of good faith and fair dealing.

A. The Jury's Verdict in favor of Plaintiffs Horizon and Geoff Pepper on their Breach of Contract Claim

**2 [1][2] The court first addresses defendants' argument that they are entitled to judgment as a matter of law on the jury's liability finding with respect to Horizon and Mr. Pepper's breach of contract claim. Judgment as a matter of law under Rule 50(b) "should be cautiously and sparingly granted," Black v. M & W Gear Co., 269 F.3d 1220, 1268 (10th Cir.2000), and is appropriate only if the evidence, viewed in the light most favorable to the nonmoving party, "points but one way and is susceptible to no reasonable inferences supporting the party opposing the motion." Sanjuan v. IBP, Inc., 275 F.3d 1290, 1293 (10th Cir.2002). In determining whether judgment as a matter of law is proper, the court may not weigh the evidence, consider the credibility of witnesses, or substitute its judgment for that of the jury. See Turnbull v. Topeka State Hosp., 255 F.3d 1238, 1241 (10th Cir.2001).

[3] In essence, the court must affirm the jury verdict if, viewing the record in the light most favorable to the nonmoving party, it contains evidence upon which the jury could properly return a verdict for the nonmoving party. See Roberts v. Progressive Independence, Inc., 183 F.3d 1215, 1219-20 (10th Cir.1999) (citing Harold Stores, Inc. v. Dillard Dep't Stores, Inc., 82 F.3d 1533, 1546 (10th Cir.1996)). Conversely, the court must enter judgment as a matter of law in favor of the moving party if "there is no legally sufficient evidentiary basis ... with respect to a claim or defense ... under the controlling law." Deters v. Equifax Credit Information Servs., Inc., 202 F.3d 1262, 1268 (10th Cir.2000) (quoting Harold, 82 F.3d at 1546-47).

[4] In their papers, defendants assert that, as a matter of law, they did not breach the express terms of the purchase agreement or the implied terms of the purchase agreement. The jury was instructed that they could find in favor of plaintiffs on plaintiffs' breach of contract claim if they found that plaintiffs had proved a breach of one or more express terms or a breach of the implied duty of good faith and fair dealing. See Jury Instruction 12. Because the court concludes that there was ample evidence presented at trial to support a finding that defendants breached the implied covenant of good faith and fair dealing, the court declines to address defendants' arguments concerning whether the evidence was sufficient to support a finding that defendants had breached any express terms of the purchase agreement.

[5] According to defendants, plaintiffs' claim for breach of the implied covenant of good faith and fair dealing fails as a matter of law because it purports to "add wholly new terms to the contract" and "requires the court to rewrite or supply omitted provisions to the purchase agreement in contravention of Delaware law." [FN1] This is, of course, an accurate statement of Delaware law. See, e.g., Cincinnati SMSA Limited Partnership v. Cincinnati Bell Cellular Systems Co., 708 A.2d 989, 992 (Del.1998) ("Delaware observes the well-established general principle that ... it is not the proper role of a court to rewrite or supply omitted provisions to a written agreement."). Nonetheless, Principles of good faith and fair dealing permit a court to imply certain terms in an agreement so as to honor the parties' reasonable expectations when those obligations were omitted, in the literal sense, from the text of the written agreement but can be understood from the text of the agreement. Id. In determining whether to imply terms in an agreement, the proper focus is on "what the parties likely would have done if they had considered the issue involved." Id.

FN1. The parties do not dispute that Delaware law governs plaintiffs' claim that defendants breached the terms of the purchase agreement, as that agreement contains an express choice-of-law provision.

**3 Nothing in this court's instructions to the jury would have permitted the jury to "rewrite" the purchase agreement or to inject into that agreement wholly new terms. In fact, the jury was instructed, entirely consistent with Delaware law, that they should consider "whether it is clear from what was expressly agreed upon by the parties that the parties would have agreed to prohibit the conduct complained of as a breach of the agreement had they thought to negotiate with respect to that matter." See Jury Instruction 12. Defendants argue in their papers that Mr. Pepper did not demonstrate at trial that the parties would have agreed to prohibit the challenged conduct if they had thought to negotiate about such conduct. Of course, defendants also made this argument to the jury. The jury rejected the argument...
and there was more than sufficient evidence presented at trial to support that conclusion.

For example, the jury could have readily concluded that, in light of the express agreement that plaintiffs would have an opportunity to realize up to $5.2 million in earn-out consideration (defined in the agreement itself as part of the "purchase price"), that the parties would have agreed, had they thought about it, that defendants would not be permitted to undermine Mr. Pepper's authority as president of Genmar Kansas; to abandon the Horizon brand name entirely; to mandate production of Ranger and Crestliner brands at the Genmar Kansas facility to the detriment of the Horizon brand; or to reimburse Genmar Kansas at only "standard cost".[FN2] for the manufacture of Ranger *1258 and Crestliner boats thereby impairing realization of the earn-out. If the jury concluded that defendants had engaged in such conduct (and there was sufficient evidence to draw such a conclusion), then the jury was free to conclude that such conduct was inconsistent with the spirit of the agreement concerning the earn-out consideration and that such conduct constituted a breach of the implied covenant of good faith and fair dealing. In short, there is evidence in the record upon which a jury could properly return a verdict for Horizon and Mr. Pepper on their breach of contract claim. Judgment as a matter of law, then, is not appropriate.

FN2. The undisputed evidence at trial was that "standard cost" was the amount that it actually cost Genmar Kansas to build the boat in terms of labor, material and overhead. In other words, Genmar Kansas was not making any profit on Ranger or Crestliner boats and, in most instances, was actually losing money on these boats because Genmar Kansas was not operating at maximum efficiency. Profits on these boats that were built on the production line in the Genmar Kansas facility were earned by Ranger and Crestliner when they in turn sold the boats to their dealer network.

[6] Defendants also assert that they are entitled to judgment as a matter of law on Horizon and Mr. Pepper's breach of contract claim because plaintiffs failed to present evidence upon which a reasonable jury could have concluded that defendants acted in bad faith. In support of this argument, defendants point to a Delaware Supreme Court decision defining "bad faith" as "the conscious doing of a wrong because of a dishonest purpose or moral obliquity; it is different from the negative idea of negligent in that it contemplates a state of mind affirmatively operating with furtive design or ill will." See Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P., 624 A.2d 1199, 1209 n. 16 (Del.1993). According to defendants, the evidence concerning defendants' course of conduct demonstrates only that defendants were attempting to make a profit and that no evidence was presented that defendants were acting with any furtive design or ill will.

**4 [7] As an initial matter, the jury was instructed that a "violation of the implied covenant of good faith and fair dealing implicitly indicates bad faith conduct." See Jury Instruction 12. Thus, the court's instruction certainly requires that defendants' conduct reflect some element of bad faith. While the jury was not required to find specifically that defendants acted with furtive design or ill will in order to find that defendants had breached the covenant of good faith and fair dealing, defendants have not directed the court to any cases suggesting that proof of a breach of the duty of good faith and fair dealing is inadequate in the absence of proof of some furtive design or ill will. Certainly, the Desert Equities case does not suggest such a conclusion. There, the court defined "bad faith" only for purposes of contrasting the nature of that claim with a fraud claim in explaining why it was rejecting the defendants' argument that a plaintiff must plead with particularity under Rule 9(b) a claim of bad faith. See 624 A.2d at 1208. The court, then, rejects defendants' suggestion that evidence of some furtive design or ill will was necessary for a finding of liability on plaintiffs' claim that defendants breached the covenant of good faith and fair dealing. See True North Composites, LLC v. Trinity Indus., Inc., 191 F.Supp.2d 484, 517-18 (D.Del.2002) (rejecting argument that claimant must prove that the other party acted "with furtive design or ill will" in order to prove a breach of the covenant of good faith and fair dealing).

In any event, even assuming that plaintiffs were required to prove that defendants acted with furtive design or ill will *1259 in order to prove a breach of the covenant of good faith and fair dealing, copious evidence was presented at trial demonstrating that defendants acted with the requisite "dishonest purpose" or "furtive design." There was ample evidence, for example, that defendants had ulterior motives for acquiring Horizon Marine, including the desire to remove a potentially significant competitor from the market and the desire to obtain a facility in the "southern" market dedicated primarily to the production of Ranger boats. There was also
substantial evidence demonstrating that defendants' course of conduct was intended to benefit defendants' bottom line to the financial detriment of Mr. Pepper.

In that regard, the jury could reasonably have concluded that defendants' efforts to undermine Mr. Pepper's authority as president of Genmar Kansas and their decisions to abandon the Horizon brand name entirely, to mandate the production of Ranger and Crestliner brands at the Genmar Kansas facility and to reimburse Genmar Kansas at only "standard cost" for the manufacture of Ranger and Crestliner boats were all designed to either force Mr. Pepper to quit his employment (thereby extinguishing Mr. Pepper's right to collect any earn-out) or prevent Mr. Pepper from achieving the profit margins necessary to realize his earn-out (because the formula pursuant to which the earn-out was calculated was weighted heavily in favor of the production of Horizon boats). While defendants urge that such a characterization of the evidence simply makes no sense because defendants themselves made no money on the Horizon Marine acquisition (an argument that defendants presented at length to the jury), the evidence was sufficient to support the conclusion that defendants believed (but were ultimately incorrect) that they could still turn a profit through the production of Ranger and Crestliner boats at Genmar Kansas while simultaneously preventing Mr. Pepper from realizing any earn-out by stifling the production of Horizon boats and reimbursing Genmar Kansas only at standard cost for the production of other boats. Simply put, ample evidence was presented from which the jury could reasonably conclude that defendants' conduct, taken as a whole, was in "bad faith," regardless of how that phrase is defined.

**5 In sum, the evidence presented at trial was more than adequate for the jury to conclude that defendants breached the implied covenant of good faith and fair dealing. Defendants' motion on this issue is denied.

B. The Jury's Award of $2.5 Million for Lost Earn-Out Consideration

Defendants contend that they are entitled to judgment as a matter of law on Horizon and Mr. Pepper's claim for damages for two separate but related reasons. First, defendants assert that plaintiffs presented no evidence whatsoever for the jury to ascertain what position plaintiffs would have been in if the purchase agreement had been properly performed. Second, defendants assert that Delaware law precludes any recovery because Genmar Kansas was a new business with no profit history and no evidence was presented from which the jury could conclude that Genmar Kansas was reasonably certain to realize the gross profit margins necessary to achieve any earn-out under the agreement. In the alternative, defendants seek an order remitting the award to nominal damages of one dollar or a new trial on the issue of damages.

1. Judgment as a Matter of Law

[8] The jury was instructed that if they found that defendants had breached the purchase agreement and that plaintiffs sustained damages as a result of that *1260 breach, then Horizon and Mr. Pepper were entitled to compensation "in an amount that [would] place them in the same position they would have been in if the purchase agreement had been properly performed." See Jury Instruction 13. According to defendants, plaintiffs made no effort to explain to the jury how, assuming defendants had performed their contractual obligations in good faith, Genmar Kansas would have ever met the requisite gross profit margins or generated the gross revenues necessary to entitle them to substantial earn-out payments. Stated another way, defendants urge that there was simply no evidence presented at trial that Genmar Kansas would have been profitable absent defendants' breach of the purchase agreement.

The evidence presented at trial, however, was more than sufficient to permit the jury to conclude that Genmar Kansas would have been profitable absent defendants' breach. Mr. Pepper, for example, testified on the second day of his direct examination that, in his mind, the requisite 13 percent gross profit margin was reasonable and obtainable based on his prior experience with other industry boat companies. According to Mr. Pepper, he had worked for other companies where the gross profit margins ranged from 15 percent to 30 percent, so the 13 percent figure seemed "low" to him. Mr. Pepper further testified that during the time that he was responsible for directing Lowe's manufacturing operations, [*FN3] Lowe achieved gross profit percentages in the range of 30 percent. Mr. Pepper cautioned, however, that he needed a certain level of autonomy with respect to the management of Genmar Kansas to ensure that Genmar Kansas would realize the profits and revenues necessary for Mr. Pepper to obtain the earn-out. Specifically, Mr. Pepper testified on the first day of his direct examination that he sought (and received) assurances from Mr. Oppegaard and Mr. Cloutier that they would "allow [him] to do what is necessary in managing the company to obtain that earn-out." According to Mr. Pepper, Mr. Oppegaard further assured him that he would be in control of Genmar Kansas' operations and that he would be able...
to make the "operation decisions necessary" to obtain the earn-out.

FN3. Lowe is another aluminum boat manufacturing company. Mr. Pepper worked for Lowe for nearly ten years; ultimately Lowe was purchased by defendants.

**6 The evidence presented at trial was also sufficient from which the jury could conclude that Horizon Marine, just prior to defendants' acquisition, was about to "break into the black" and turn a profit. Mr. Pepper, for example, testified on the first day of his direct examination that Horizon Marine was enjoying significant progress in late 1997 and the first six months of 1998. Mr. Pepper fully expected Horizon Marine to start making a profit in 1998. Indeed, the opinions and perspectives of other people associated with the acquisition lent additional credence to Mr. Pepper's beliefs. Mr. Pepper testified on direct examination, for example, that Bill Ek, a consultant for defendants who visited the Horizon Marine facility in November 1997, was "amazed" at "how far [Horizon Marine] had come in such a short period of time." Mr. Oppegaard testified on cross-examination that Mr. Ek had advised him that Mr. Pepper was "the best product development person in the industry." Similarly, the jury heard testimony on the first day of Mr. Pepper's direct examination that Mr. Oppegaard was impressed and excited about what Mr. Pepper had been able to accomplish with Horizon Marine in a short period of time. In fact, Mr. Oppegaard, after meeting Mr. Pepper and visiting Horizon Marine for the first time, sent an internal memorandum *1261 to his executive team in which he described Mr. Pepper and the Horizon product as "a major competitor if left alone to grow." Mr. Oppegaard also testified on cross-examination that he anticipated that Horizon Marine would grow very fast.

From this evidence, a reasonable jury could infer that if defendants had allowed Mr. Pepper to direct the daily operations of Genmar Kansas, then Mr. Pepper would have been able to achieve the requisite gross profit margins to realize the earn-out. See Harrington v. Hollingsworth, 1992 WL 91165, at *4 (Del.Super.Ct. Apr. 15, 1992) (in breach of contract case, lost income damages not speculative where commercial fisherman testified that had the defendant constructed his larger commercial fishing boat on time, he would have been able to catch more sea bass and double his annual income; fisherman's testimony was sufficient to establish damages with reasonable probability where his projections were based on bass fishing industry, an industry with which plaintiff was familiar and in which he had participated for 20 years).

Moreover, defendants attempted to demonstrate at trial-through both argument and the examination of witnesses-that plaintiffs' claim for damages based on the earn-out was unreasonable because it was uncertain whether the company would have been able to meet the requisite profit margins and revenues. Defendants' efforts in that regard apparently had some impact-the jury awarded only half of the total earn-out consideration. Presumably, then, the jury concluded that plaintiffs had not proved loss of the total earn-out amount with reasonable certainty. Finally, any doubt concerning the amount of damages sustained by plaintiffs is resolved against defendants. As the breaching party, defendants "should not be permitted to reap advantage from [their] own wrong by insisting on proof which by reason of [their] breach is unobtainable." See E. Allan Farnsworth, Contracts § 12.15 at 922 (2d ed.1990); accord Restatement (Second) of Contracts § 352 cmt. a (Any doubts in the proof of damages are resolved against the party in breach because "[a] party who has, by his breach, forced the injured party to seek compensation in damages should not be allowed to profit from his breach where it is established that a significant loss has occurred.").

**7 In a related argument, defendants contend that they are entitled to judgment as a matter of law on plaintiffs' claim for damages because, under Delaware law, "a new business with no profit history cannot obtain lost profit damages." See Defs. Br. at 7. On its face, then, defendants' argument is premised on the idea that plaintiffs' damages for lost earn-out consideration is the equivalent of an award for damages based on lost profits. Given the nature of the earn-out consideration at issue in this case, however, it is simply not appropriate to subject plaintiffs' claim for damages to a traditional lost profits analysis.

To be sure, Genmar Kansas' profitability was an important component of the earn-out formula. However, unlike those cases in which one party seeks to recover lost profits when the issue of whether that party could reasonably expect such profits is in dispute, the parties here agreed at the outset of their relationship that it was reasonable for Mr. Pepper to expect an additional $5.2 million in earn-out consideration pursuant to a formula developed by defendants. Indeed, the parties agreed that the earn-
out consideration was part of the total purchase price for the acquisition—an agreement that is reflected in Article 2 of the contract, which states that the "Cash Consideration and the Earn-Out Consideration described in Section 2.2 below are referred to in this Agreement in *1262 the aggregate as the 'Purchase Price.' " See Trial Ex. 227a § 2.1. As Mr. Pepper explained on the second day of his direct examination, defendants initially proposed the earn-out consideration as "more of an incentive-type thing" separate and apart from the purchase price. However, after multiple discussions during which Mr. Pepper, Mr. Oppegaard and Mr. Cloutier all agreed that the earn-out was obtainable and that Mr. Pepper would be given the requisite autonomy to obtain the earn-out, defendants ultimately agreed to include the earn-out as part of the purchase price.

While both parties agreed at trial that the earn-out was not a "guarantee," ample evidence was presented that all parties believed there to be "reasonable probability" that Mr. Pepper would realize the full amount of the earn-out. Indeed, on his direct examination, Mr. Pepper testified that both Mr. Cloutier and Mr. Oppegaard assured him that the earn-out was obtainable. On his cross-examination, Mr. Pepper testified that he advised his investors in writing that "the management of Horizon believes there is a reasonable probability that ... the earn-out consideration will be achieved." Similarly, Mr. Cloutier testified on direct examination that he believed at the time of the transaction that Mr. Pepper had a "very realistic" opportunity to achieve the earn-out. Moreover, on cross-examination, Mr. Cloutier testified that he believed that the earn-out portion of the purchase agreement was achievable based in part on defendants' own internal projections.

**8** In their papers, defendants now characterize their assurances and beliefs that the earn-out was obtainable as mere "pre-contractual guesswork" and contend that to permit plaintiffs to recover damages based on such guesswork without considering Genmar Kansas' "actual performance" is to provide plaintiffs with an "unwarranted windfall." This argument, however, ignores the significance of the jury's implicit finding that Genmar Kansas' actual performance would have been different (indeed, it would have been profitable) had defendants performed their obligations under the purchase agreement consistent with plaintiffs' reasonable expectations. In other words, the jury apparently found that defendants' conduct, including undermining Mr. Pepper's managerial authority and requiring increased production of multiple models of Ranger boats, had the effect of rendering Mr. Pepper unable to perform as he had planned, unable to operate Genmar Kansas appropriately and ultimately unable to succeed in achieving any earn-out consideration. For these reasons, defendants' reliance on the actual performance of Genmar Kansas as a basis for judgment as a matter of law is misplaced.

In sum, the court rejects defendants' attempt to analyze plaintiffs' claim for damages as one for lost profits. The jury's award of $2.5 million is not speculative and is supported by evidence that Genmar Kansas would have been profitable and that the earn-out would have been obtainable if defendants had performed in good faith their obligations under the purchase agreement.

2. Remittitur

[10][11] As an alternative to their argument that they are entitled to judgment as a matter of law on plaintiffs' claim for damages in the form of lost earn-out, defendants maintain that this court should enter a remittitur reducing the $2.5 million verdict to nominal damages of one dollar in light of the "utterly speculative nature" of the lost earn-out damages. Of course, the court has already concluded that the jury's award of $2.5 million was not speculative, so the motion for remittitur is denied. In any event, under Delaware law, the court may order a remittitur only if the verdict *1263 "is so grossly out of proportion as to shock the Court's conscience." See Gillenardo v. Connor Broadcasting Delaware Co., 2002 WL 991110 at *10 (Del.Super.Ct. Apr. 30, 2002) (citing Mills v. Telenczak, 345 A.2d 424, 426 (Del.1975)); see also Century 21 Real Estate Corp. v. Meraj Int'l Investment Corp., 315 F.3d 1271, 1281 (10th Cir.2003) (in assessing measure of damages awarded pursuant to contract containing choice of law provision, district court must follow state's law-absent any argument that choice of law provision is unenforceable-including that state's law concerning remittitur).

Again, the jury had before it sufficient evidence to conclude that plaintiffs would have realized a significant portion of the earn-out consideration had defendants performed in good faith their obligations under the contract. The $2.5 million verdict represents exactly half of the entire earn-out portion of the purchase agreement and exactly half of what the plaintiffs sought to recover on their breach of contract claim. The award is not excessive, it is not unreasonable, it does not shock the court's conscience and, thus, it will not be remitted. See id. at 1282-83 (affirming district court's refusal to remit $700,000
verdict on breach of contract claim, despite concerns about reliability of testimony concerning lost profits and "unrealistic" projections; district court reviewed award under "shock the conscience" standard).

3. New Trial

**9 [12]** Defendants' final arguments with respect to the jury's verdict on plaintiffs' breach of contract claim is that they are entitled to a new trial because the verdict is against the weight of the evidence and the result of passion and prejudice. Delaware law permits a district court to set aside a verdict and order a new trial only if "the evidence preponderates so heavily against the jury verdict that a reasonable jury could not have reached the result." See Gannett Co. v. Re, 496 A.2d 553, 558 (Del. 1985). For the reasons set forth above in connection with defendants' motion for judgment as a matter of law, the court concludes that evidence presented at trial was sufficient for the jury to have reached the result that it did. Similarly, for the reasons explained above, the court cannot conclude that the verdict is so clearly excessive as to indicate that it was the result of passion or prejudice. See Yankanwich v. Wharton, 460 A.2d 1326, 1332 (Del. 1983) ("A verdict will not be disturbed as excessive unless it is so clearly so as to indicate that it was the result of passion, prejudice, partiality, or corruption; or that it was manifestly the result of disregard of the evidence or applicable rules of law."). The jury's verdict of $2.5 million on plaintiffs' breach of contract claim will stand.

C. The Jury's Verdicts in favor of Cassandra O'Tool and John O'Tool

The jury also found in favor of Cassandra O'Tool and John O'Tool on their claims that defendants breached the O'Tools' employment contracts. The jury awarded Ms. O'Tool the sum of $63,200 and Mr. O'Tool the sum of $20,313. Defendants assert that they are entitled to judgment as a matter of law on the O'Tools' claims for breach of their employment contracts or, in the alternative, that they are entitled to a remittitur reducing the damages awarded to the O'Tools. For the reasons explained below, defendants' motion is denied.

1. Judgment as a Matter of Law

**13** At trial, Cassandra and John O'Tool argued that defendants breached the express terms of their respective employment agreements. Specifically, the O'Tools maintained that, pursuant to the express language of their employment agreements, defendants could not discharge Mr. or Ms. O'Tool prior to the end of an initial three-year employment period except in four narrow circumstances and that they were not discharged for any of those four reasons. In support of their argument, the O'Tools highlighted for the jury section 3 and section 7 of their employment agreements:

3. Term of Employment. This Agreement shall have a term of three (3) years, subject to earlier termination pursuant to the provisions of Section 7 hereof.


7. Termination and Severance.

(a) This Agreement may be terminated prior to the end of the three (3) year term by Genmar Kansas for (i) cause, (ii) lack of adequate job performance as determined by Genmar Kansas' President and the President of Genmar Holdings, (iii) death of Employee, or (iv) disability of Employee.

Defendants attempted to convince the jury, and now the court, that the O'Tools were terminated for "lack of adequate job performance" consistent with section 7 of their employment contracts. The jury clearly rejected defendants' argument and, in finding that defendants breached the O'Tools' employment contracts, concluded that the O'Tools were not terminated for inadequate job performance or any other reason set forth in section 7. Indeed, ample evidence was presented at trial to support the jury's conclusion. In that regard, the jury could have concluded (and presumably did conclude) that the O'Tools were terminated not because of any performance issues but because of their familial ties with Geoff Pepper, the key individual with whom defendants were attempting to sever their relationship. In other words, the jury could have easily concluded from the evidence presented at trial that defendants terminated Mr. and Mrs. O'Tool because defendants believed it would be awkward to retain the O'Tools after terminating Geoff Pepper.

Another possibility, equally supported by the evidence, is that the jury concluded that the O'Tools were terminated for inadequate job performance but that the assessment of their job performance was not, as required by section 7, "determined by Genmar Kansas' President and the President of Genmar Holdings." Specifically, the jury could have
concluded that Mr. Pepper was still serving as the president of Genmar Kansas during the relevant time period and that Mr. Pepper had not determined that his daughter and son-in-law were performing inadequately. Moreover, the jury could have concluded from the evidence presented at trial that Mr. Oppegaard, the president of Genmar Holdings, had simply not made an assessment of the O'Tools' job performance. In fact, Mr. Oppegaard testified at trial that he had never discussed with Mr. Pepper the adequacy of the O'Tools' job performance and that he did not make the decision to terminate the O'Tools.

Defendants also reiterate their argument (made at the summary judgment stage, to the court at the close of plaintiffs' case and to the jury throughout the trial) that Section 12 of the O'Tools' employment agreements eviscerates any notion that the O'Tools were guaranteed employment for a three-year term. [FN4] Section 12 of the *1265 agreement, entitled "Miscellaneous," contains the following sentence: "This Agreement shall not give Employee any right to be employed for any specific time or otherwise limit Genmar Kansas' right to terminate Employee's employment at any time with or without cause." As the court noted in its summary judgment order, however, any ambiguity created when sections 3 and 7 are read together with section 12 was for the jury to resolve and defendants certainly are not entitled to judgment as a matter of law on the O'Tools' breach of contract claims based on the language of section 12. See Horizon Holdings, L.L.C. v. Genmar Holdings, Inc., 241 F.Supp.2d 1123, ----, 2002 WL 31255580, at *19 (D.Kan. Oct. 2, 2002). Moreover, the jury could have concluded that section 12, read literally, gives only Genmar Kansas the right to terminate Employee's employment at any time with or without cause. FN4. In their papers, defendants also assert that section 4 of the employment agreements supports their argument that the O'Tools were not guaranteed a specific term of employment. Defendants, however, have not mentioned section 4 at any time prior to filing their renewed motion and certainly did not highlight this section for the jury.

In sum, the court certainly cannot conclude as a matter of law that the O'Tools were terminated for lack of adequate job performance consistent with section 7 of their employment agreements or that the O'Tools were not guaranteed any specific term of employment. The record contains more than sufficient evidence upon which the jury could properly return a verdict for the O'Tools on their breach of contract claims.

2. Remittitur

[14] In the alternative, defendants urge that the damages awarded by the jury to the O'Tools are excessive and against the weight of the evidence and, as a result, they ask the court to enter an order of remittitur reducing the awards. The court begins with defendants' arguments concerning the jury's award of $63,200 to Ms. O'Tool. According to defendants, Ms. O'Tool's lost wages for the relevant time period were only $52,000 and thus, the jury must have awarded Ms. O'Tool more than $11,000 in lost MIP earnings (a bonus pursuant to defendants' Management Incentive Program). Defendants urge that the $52,000 in lost wages must be reduced because the jury failed to deduct from this amount any wages that Ms. O'Tool could have earned if she had made reasonable efforts to obtain other employment.


Defendants further contend that the jury's calculation of Ms. O'Tool's lost MIP earnings was inaccurate. Consistent with the evidence presented by plaintiffs at trial, the jury apparently awarded Ms. O'Tool approximately $11,000 in lost MIP earnings, *1266 representing 20 percent of Ms. O'Tool's salary. Significantly, defendants do not contest that Ms.
O'Tool's employment agreement provided that her MIP compensation would be 20 percent of her salary assuming that both Genmar Holdings and Genmar Kansas met their operating profit goals. Moreover, defendants do not contest that 20 percent of Ms. O'Tool's salary over the relevant 15-month period at issue (the time of her termination through the time when Ms. O'Tool's employment contract would have expired) would be roughly $11,000.\footnote{6} Rather, defendants urge that the jury incorrectly assumed that both Genmar Holdings and Genmar Kansas would have met their operating profit goals during the relevant time frame—an assumption that defendants characterize as "clearly erroneous" in light of the fact that Genmar Kansas never reached the operating profits necessary to generate MIP payments.

\footnote{6} In their papers, defendants assert that 20 percent of Ms. O'Tool's salary is only $8320. That figure, however, is based on Ms. O'Tool's annual salary of $41,600 instead of the total salary that Ms. O'Tool would have earned over the relevant 15-month period.

**12\footnote{16}** Similarly, defendants contend that the jury improperly calculated Mr. O'Tool's lost MIP earnings when it awarded him $20,313. In that regard, the jury's verdict represents only lost MIP earnings as it was undisputed that Mr. O'Tool earned more money in his subsequent job than he would have earned if he had stayed at Genmar Kansas. Defendants do not dispute that Mr. O'Tool's employment contract provided that his MIP compensation would be 25 percent of his salary (assuming that both Genmar Holdings and Genmar Kansas met their operating profit goals). Defendants also do not dispute that the jury's verdict of $20,313 represents almost to the penny 25 percent of Mr. O'Tool's annual salary of $65,000 over the course of 15 months.\footnote{7} Again, defendants maintain only that the jury incorrectly assumed (or wildly speculated) that both Genmar Holdings and Genmar Kansas would have met their operating profit goals during the relevant time frame and that, in fact, Genmar Kansas never met the requisite profit goals.

\footnote{7} When Mr. O'Tool's annual salary is translated into a monthly salary, and that monthly salary is multiplied by 15 months (measured from the time of Mr. O'Tool's discharge through the time when Mr. O'Tool's employment contract would have expired), his total lost salary is $81,249.90 (65,000/12 = $5,416.66 per month x 15). Twenty-five percent of $81,249.90 is $20,312.47.

Of course, defendants had the opportunity to make this argument to the jury and did, in fact, make this argument to the jury. The jury, as it was entitled to do, rejected this argument and plainly adopted plaintiffs' theory, thoroughly developed at trial, that Genmar Kansas would have reached its operating profit goals but for defendants' breach of their obligations under the purchase agreement, including their duty of good faith and fair dealing. In short, the jury's award of $63,200 to Ms. O'Tool and $20,313 to Mr. O'Tool does not shock the conscience of this court and, thus, no remittitur will be issued. See \textit{Dougan v. Rossville Drainage Dist.; 270 Kan. 468, 486, 15 P.3d 338 (2000)} (court has the power to issue a remittitur where a verdict is so manifestly excessive that it shocks the conscience of the court); \textit{see also Century 21 Real Estate Corp. v. Meraj Int'l Investment Corp., 315 F.3d 1271, 1281 (10th Cir.2003)} (in assessing measure of damages awarded pursuant to contract containing choice of law provision, district court must follow chosen state's law-absent any argument that choice of law provision is unenforceable- including that state's law concerning remittitur).

*1267 D. Remaining Arguments in Support of New Trial*

Finally, defendants assert that they are entitled to a new trial pursuant to \textit{Federal Rule of Civil Procedure 59(a)} in light of two "substantial errors of law" committed by the court. Specifically, defendants contend that the court erred in admitting parol evidence of the parties' negotiations prior to the execution of the purchase agreement and that the court erred in its instruction to the jury regarding the appropriate standard for determining whether defendants breached the implied covenant of good faith and fair dealing. The court addresses each of these arguments in turn and, as explained below, rejects both arguments.

1. Admission of Parol Evidence

\footnote{17} In their motion, defendants initially argue that the court erred when it admitted, over defendants' objection, parol evidence of the parties' negotiations to support plaintiffs' claim that they were fraudulently induced into executing the purchase agreement. Curiously, defendant concedes (in the same
paragraph) that the law permits such evidence to prove fraudulent inducement. What defendants are really arguing is that parol evidence is inadmissible to prove bad faith in a breach of contract claim and that the jury should not have been permitted to consider evidence of the parties' negotiations (and, more specifically, oral assurances made to plaintiffs by defendants prior to the execution of the agreement) in connection with plaintiffs' claim that defendants breached the implied duty of good faith and fair dealing. [FN8]

FN8. This argument presupposes that the jury considered such evidence in connection with plaintiffs' breach of contract claim. Defendants, of course, have no way of knowing that the jury did, in fact, consider such evidence in its assessment of the breach of contract claim.

**13 [18] While defendants objected at trial to the admission of parol evidence concerning the parties' negotiations, they did not, once the court ruled that such evidence was clearly admissible with respect to plaintiffs' fraud claim, request a limiting instruction or even raise the issue of whether such evidence was admissible with respect to plaintiffs' breach of contract claim. In fact, defendants concede, as they must, that they failed to request a limiting instruction. Defendants, however, urge that parol evidence is a rule of substantive law that is not waived by the failure to object to its admission. See Carey v. Shellburne, Inc., 224 A.2d 400, 402 (Del.1966). While this is certainly true, there is nonetheless an evidentiary objection-relevance under Federal Rules of Evidence 401 and 402—that defendants should have made (and did not) if they desired to preclude the jury from considering such evidence with respect to plaintiffs' breach of contract claim. Because defendants failed to raise a timely objection to the admission of such evidence on that basis and request a limiting instruction, the court reviews the admission of the evidence under the "plain error" standard. See Fed.R.Evid. 103(d).

[19][20] The court readily concludes that the admission of evidence concerning the parties' negotiations prior to executing the purchase agreement was not plain error. In fact, the point largely is moot because the court, even if defendants had brought the issue to the court's attention at trial, would have permitted the jury to consider such evidence in connection with plaintiffs' claim that defendants breached the implied covenant of good faith and fair dealing. In other words, the court would have overruled any objection that defendants might have made in this regard.

*1268 [21] The parol evidence rule requires the court to exclude "extraneous evidence that varies or contradicts the terms of a unified written instrument." True North Composites, LLC v. Trinity Indus., Inc., 191 F.Supp.2d 484, 514 (D.Del.2002) (citation omitted). Because defendants have not shown (much less argued) that the evidence presented at trial concerning the parties' negotiations varied or contradicted the terms of the purchase agreement, such evidence simply does not require invocation of the parol evidence rule. Moreover, because the purchase agreement was silent with respect to the majority of the issues discussed by the parties prior to the execution of the agreement (e.g., the number of Ranger boats that Genmar Kansas would be expected to produce or whether Genmar Kansas would be expected to produce any sister-brand boats at all), evidence concerning the parties' pre-acquisition negotiations is entirely appropriate to provide context for plaintiffs' claim that defendants breached their duty of good faith and fair dealing. See id. at 514-15 (denying motion for new trial based on court's alleged error in admitting parol evidence of transaction underlying written agreement because evidence provided context to good-faith-and-fair-dealing claims and testimony did not vary or contradict the terms of the agreement).

**14 In other words, evidence concerning what the parties discussed prior to executing the agreement, to the extent such evidence, as here, does not contradict the agreement, is entirely relevant to whether defendants breached the covenant of good faith and fair dealing because the parties' reasonable expectations at the time of the contract formation determine the reasonableness of the challenged conduct. See id. at 516 (evidence concerning course of dealings between the parties prior to execution of agreement was relevant to claim that party breached the covenant of good faith and fair dealing because such evidence illuminated the parties' expectations of each other at the time of contract formation).

To conclude, then, defendants have not shown that the parol evidence rule required exclusion, at least for purposes of plaintiffs' breach of contract claim, of evidence concerning the parties' negotiations prior to the execution of the purchase agreement. The court rejects defendants' contention that it erred by allowing the jury to consider such evidence.

2. The Good Faith and Fair Dealing Instruction
Defendants’ final argument in support of their motion for a new trial is that the court erred in its instruction to the jury concerning the duty of good faith and fair dealing. In its instructions, the court explained the duty, under Delaware law, as follows:

"The law imposes a duty of good faith and fair dealing in every contract. This duty is a contract term implied by courts to prevent one party from unfairly taking advantage of the other party. This duty includes a requirement that a party avoid hindering or preventing the other party’s performance. The implied covenant of good faith and fair dealing emphasizes faithfulness to an agreed common purpose and consistency for the justified expectations of the other party. The parties’ reasonable expectations at the time of the contract formation determines the reasonableness of the challenged conduct. A violation of the implied covenant of good faith and fair dealing implicitly indicates bad faith conduct. In determining whether defendants breached the implied covenant of good faith and fair dealing, you may consider whether it is clear from what was expressly agreed upon by the parties that the parties would have agreed to prohibit the conduct complained of as a breach of the agreement had they thought to negotiate with respect to that matter."

_def. Proposed Instruction 5. This proffered language is derived from Corporate Property Associates v. Hallwood Group Inc., 792 A.2d 993 (Del. Ch. 2002), a trial court decision from the Court of Chancery in Delaware. In that case, a commercial dispute, the Vice Chancellor stated that a claimant seeking to prove a breach of the implied covenant of good faith and fair dealing "must also demonstrate that the conduct at issue involved 'an aspect of fraud, deceit or misrepresentation.'" Def. at 1003. At the instruction conference, defendants relied solely on the Corporate Property case to support their proffered instruction. Indeed, defendants did not direct the court to any other Delaware case—much less a Delaware Supreme Court case or a federal case interpreting Delaware law—in which a court required a finding of fraud, deceit or misrepresentation to support a breach of the covenant of good faith and fair dealing in the context of a commercial transaction.

As the court explained at the conference, the trial court in Corporate Property cites only to Merrill v. Creathall-American, Inc., 606 A.2d 96, 101 (Del. 1992) in support of the "fraud, deceit or misrepresentation" language. The Merrill case involved an employment-at-will contract and the court held that when the conduct of an employer in the employment-at-will context rises to the level of fraud, deceit or misrepresentation, then the employer will have violated the implied covenant of good faith and fair dealing. _Id._ Interestingly, the Merrill court, in turn, relies on two cases from two other state courts in support of its conclusion that an element of fraud, deceit or misrepresentation must be present before an employer violates the covenant of good faith and fair dealing. _Id._ Those cases, Magnan v. Anaconda Indus., Inc., 37 Conn. Supp. 38, 429 A.2d 492 (1980) and A. John Cohen Ins. v. Middlesex Ins. Co., 8 Mass. App. Ct. 178, 392 N.E.2d 862 (1979), both arise in the employment-at-will context. In the limited and unique context of employment-at-will, requiring an employee to prove that his or her employer's conduct amounted to fraud in order to

FN9. While the court in True North referenced § 205(a) of the Restatement (Second), that Restatement does not contain a § 205(a); the court intended to reference comment a of § 205.
show a breach of the duty of good faith and fair dealing is entirely consistent with the notion of an at-will employment relationship. For in the absence of a showing of fraud, the covenant of good faith and fair dealing could not operate in the employment-at-will context without wholly defeating the benefit for which the parties bargained—i.e., the employer's ability to discharge the employee and the employee's ability to quit his or her employment for good reason, bad reason or no reason at all. Stated another way, parties to an at-will employment relationship are generally not subjected to any good faith standard.

[FN10] On the other hand, in the context of a commercial transaction like the one presented here, the implied covenant of good faith and fair dealing—as it is typically applied (i.e., without a requirement of fraud)—does not conflict with the benefit for which parties to a commercial transaction generally bargain. For these reasons, the court reiterates its belief that the trial court in *Corporate Property* incorrectly incorporated into the commercial context the "fraud, deceit or misrepresentation" language from the employment-at-will context of *Merrill.* [FN11] Defendants, for the first time, now also cite to a Delaware Supreme Court case that they assert rejects the distinct that this court has drawn between the commercial context and employment-at-will context. Specifically, defendants rely on *Cincinnati SMSA Limited Partnership v. Cincinnati Bell Cellular Systems Co.,* 708 A.2d 989 (Del.1998) and contend that in *Cincinnati Bell* the Delaware Supreme Court "made clear that the same standard applied by the Delaware court in *Merrill* should also be applied in the commercial contract context." Defendants' characterization of the *Cincinnati Bell* case is simply inaccurate; in fact, that case supports this court's conclusion that any requirement that a party prove fraudulent conduct to demonstrate a violation of the duty of good faith and fair dealing is limited to the employment-at-will context.

**16 In *Cincinnati Bell,* the Delaware Supreme Court reviewed a decision by the Court of Chancery dismissing, pursuant to Rule 12(b)(6), a good faith and fair dealing claim arising in the context of a limited partnership agreement. *Id.* at 990. Specifically, the Delaware Supreme Court affirmed the lower court's conclusion that the implied covenant of good faith and fair dealing could not provide a basis for implying additional noncompete obligations in a limited partnership agreement where the agreement's noncompete clause was unambiguous. *Id.* at 993-94. In so holding, the *Cincinnati Bell* court emphasized that "implying obligations based on the covenant of good faith and fair dealing is a cautious enterprise." *Id.* at 992.

*1271 Tracing the development of the implied covenant under Delaware law, the court in *Cincinnati Bell* noted that the *Merrill* case was the first case in which the court "first recognized the limited application of the covenant to inducement representations in at-will employment contracts." *Id.* The *Cincinnati Bell* court further noted that in *Merrill,* the court "was careful to heed the legal right of employers to pursue a certain amount of self-interest in the creation of contractual relationships" and "held that, to plead properly a claim for breach of an implied covenant of good faith and fair dealing in the inducement of employment, a plaintiff must allege 'an aspect of fraud, deceit or misrepresentation.' " *Id.* at 992-93 (quoting *Merrill,* 606 A.2d at 101-02). The court in the *Cincinnati Bell* case then stated, "[t]his Court should be no less cautious or exacting when asked to imply contractual obligations from the written text of a limited partnership agreement." *Id.* at 993. Defendants argue that this single sentence clearly illustrates an intent by the Delaware Supreme Court to incorporate the fraud standard of the employment-at-will context into the commercial transaction context. A full reading of *Cincinnati Bell,* however, indicates that the court was simply stressing the narrow scope of the implied covenant and that application of the covenant is a "cautious enterprise." *Id.* at 992-93.
There is no indication in *Cincinnati Bell* that the court utilized the fraud standard of *Merrill* in resolving the appeal. In short, *Cincinnati Bell* in no way suggests that the jury in this case should have been instructed that plaintiffs were required to prove that defendants acted fraudulently in order to prove a breach of the implied covenant and, more importantly, the court believes that the Delaware Supreme Court, if faced with the issue, would refuse to adopt such a requirement.

Moreover, defendants' construction of Delaware law on good faith and fair dealing is illogical as it would render a good faith and fair dealing claim entirely duplicative of a fraud claim. In fact, defendants essentially contend that plaintiffs' good faith and fair dealing claim should be converted into one of fraud. Under defendants' theory, then, plaintiffs could not prevail on their good faith and fair dealing claim without also prevailing on their fraud claim. Any distinction, then, between the two claims would be lost. Such a result would be untenable, as the Delaware Supreme Court obviously recognizes a distinction between the two claims. See *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1207-08 (Del.1993) (distinguishing claim of fraud from allegations of bad faith).

**17** Finally, defendants contend that the court's instruction on the duty of good faith and fair dealing was erroneous because it failed to inform the jury that plaintiffs were required to show affirmative acts of bad faith on the part of defendants. The court's instruction advised the jury that a violation of the implied covenant of good faith and fair dealing "implicitly indicates bad faith conduct." While defendants may have preferred different language concerning bad faith, they have not identified how the court's instruction departs from or incompletely portrays Delaware law. Moreover, defendants have not demonstrated why plaintiffs' proof of a breach of the duty of good faith and fair dealing is inadequate without further proof of affirmative acts of bad faith conduct. The court, then, rejects defendants' argument that the instruction was erroneous. See *True North. 191 F.Supp.2d at 517-18* (rejecting argument that instruction was erroneous because it failed to advise that the claimant must prove that the other party acted in bad faith where movant failed to show how the court's instruction was inconsistent with Delaware law).

FN12 In their motion to alter or amend, plaintiffs also point out that the judgment entered on November 21, 2002 contains a typographical error in that the judgment states that the verdict was returned by the jury on November 12, 2002. The jury, however, returned its verdict on November 21, 2002. The judgment will be corrected, and plaintiffs' motion will be granted, in this respect.

In the event that the Non-Defaulting Party is entitled to receive an amount of money by reason of the Defaulting Party's default hereunder, then, in addition to such amount of money, the Defaulting Party shall promptly pay to the Non-Defaulting Party a sum equal to interest on such amount of money accruing at the rate of 2% per month (but if such rate is not permitted under the laws of the State of Delaware, then at the highest rate which is permitted to be paid under the laws of the State of Delaware) during the period between the date such payment should have been made hereunder and the date of the actual payment thereof.

See *Purchase Agreement, Section 13.2(b) (Trial Exhibit 227a)*. Defendants oppose plaintiffs' motion for three reasons. According to defendants, the contractual rate of interest specified in the purchase agreement is preempted by the standard rate contained in 28 U.S.C. § 1961; plaintiffs have waived their right to have the judgment accrue interest at the parties' contractually agreed rate; and the contractually agreed rate is not permitted under Delaware law. As set forth below, the court concludes that parties are free to contract for a rate other than that specified in 28 U.S.C. § 1961 and, thus, the federal statute does not supersede the parties' agreement. Nonetheless, because the court concludes that plaintiffs have waived their right to assert the rate set forth in the purchase agreement by not preserving their claim of entitlement to such rate in the pretrial order and by failing to raise the issue until after the entry of judgment, the court denies plaintiffs' motion to alter or amend the judgment to...
the extent plaintiffs seek to enforce the rate established in the purchase agreement.

A. Whether Section 1961 Supersedes the Contractually Agreed Rate

Defendants contend that 28 U.S.C. § 1961, the federal statute governing post-judgment interest, must govern the award of post-judgment interest in this case despite the parties' contractual agreement for a different rate. Section 1961 states, in relevant part, that "[i]nterest shall be allowed on any money judgment in a civil case recovered in district court" and that "such interest shall be calculated from the date of the entry of the judgment, at a rate equal to the coupon issue yield equivalent (as determined by the Secretary of the Treasury) of the average accepted auction price for the last auction of the fifty-two week United States Treasury bills settled immediately prior to the date of the judgment." 28 U.S.C. § 1961(a).

In support of their argument, defendants direct the court to Wilmington Trust Co. v. Aerovias de Mexico, S.A. de C.V., 893 F.Supp. 215, 220 (S.D.N.Y.1995), where the court calculated post-judgment interest at the section 1961 rate despite a contractual agreement providing for a higher rate. In that case, the district court simply stated that the language of section 1961(a) is mandatory and must govern the interest rate on any judgment debt:

The language of [section 1961(a)] is mandatory: once a claim is reduced to judgment, the original claim is extinguished, and a new claim, called a judgment debt, arises. Section 1961(a) governs the interest rate on this judgment debt. Carte Blanche (Singapore) v. Carte Blanche (Int.), 888 F.2d 260 (2d Cir.1989), citing Kotsopoulos v. Asturia Shipping Co., 467 F.2d 91 (2d Cir.1972).

Id. at 220-21. The Wilmington case, however, is not entirely helpful for purposes of this court's analysis of whether parties can contract for a rate of interest different from the rate set forth in section 1961(a). In that regard, the district court in Wilmington did not expressly address whether the parties could contract around the federal statute. Rather, the court seemed to assume that the parties would not be permitted to do so under Second Circuit precedent. However, Carte Blanche and Kotsopoulos, the Second Circuit cases upon which the Wilmington court relies, do not stand for the proposition that parties cannot contract for a different rate of interest. In Kotsopoulos, a maritime case, the issue before the Second Circuit was only whether state law or federal law would determine the appropriate rate of post-judgment interest in admiralty and maritime cases. See 467 F.2d at 94-95. Similarly, the Second Circuit in Carte Blanche did not address whether parties to a contract could provide for a rate different than the standard rate set forth in section 1961(a). There, the Circuit held that an arbitrator could not impose a post-judgment interest rate different than the rate established in section 1961(a). See 888 F.2d at 268-69 (district court judgment affirming an arbitration award is governed by section 1961(a) rather than rate set forth in arbitration award).

Plaintiffs, on the other hand, urge that nearly every Circuit Court of Appeals to have addressed this issue has concluded that the parties can agree to an interest rate other than the standard one contained in 28 U.S.C. § 1961. For example, the Seventh Circuit in Central States, Southeast & Southwest Areas Pension Fund v. Bomar National, Inc., 253 F.3d 1011 (7th Cir.2001), affirmed a district court's award of post-judgment interest pursuant to the rate agreed upon in a pension trust agreement rather than the standard rate contained in section 1961(a). In so doing, the Seventh Circuit stated that "[i]t is well established that parties can agree to an interest rate other than the standard one contained in 28 U.S.C. § 1961." Id. at 1020. In support of its statement, the Seventh Circuit cites to the Fifth Circuit's decision in Hymel v. UNC, Inc., 994 F.2d 260, 265 (5th Cir.1993).

In Hymel, the Fifth Circuit "noted" that the district court was correct when it awarded post-judgment interest at a rate of 9 percent per annum pursuant to an express language contained in a promissory note executed by the parties. Id. at 265-66. The Circuit summarily rejected the argument that section 1961 applies in every case without exception and, in doing so, cited to another Fifth Circuit case, In re Lift & Equipment Service, Inc., 816 F.2d 1013 (5th Cir.1987). See id. In In re Lift, a case arising out of the bankruptcy court, the parties disputed whether the creditor was entitled to post-judgment interest under Louisiana law or under section 1961(a), 816 F.2d at 1018. The Fifth Circuit, however, rejected both arguments and, embracing a view that none of the parties had espoused, applied the interest rate set forth in the written assignment of accounts receivable. Id. In so doing, the Circuit stated, "While 28 U.S.C. § 1961 provides a standard rate of post-judgment interest, the parties are free to stipulate a different rate, consistent with state usury and other applicable laws." Id.

While the Fifth Circuit in In re Lift offered no explanation for its conclusion, it cited to a Ninth
Circuit decision, *Investment Service Co. v. Allied Equities Corp.*, 519 F.2d 508 (9th Cir.1975). In that case, the district court judge applied the interest rate agreed upon by the parties in a promissory note. *Id.* at 511. The guarantor of the loan argued that the assignee of the note was only entitled to the legal rate of interest under Oregon state law. See *id.* The Ninth Circuit rejected the argument:

It is true that the contractual duty here is discharged by merger once the judgment is entered on the note. *Restatement of Contracts* § 444. However, upon entry of the judgment the legal rate of interest applicable should apply unless the parties have agreed in the note that some other rate of interest shall apply. *Corbin on Contracts* § 1045 (1962).

*Id.* The court's reliance on *Corbin*, however, is somewhat puzzling in that *Corbin* does not purport to draw any conclusion about the effect of a judgment on the parties' contractual agreement to a different rate and it does not address a contractual agreement for post-judgment interest; rather, the section cited by the Ninth Circuit deals only with the payment of interest as "agreed compensation" for a breach of the contract. See *Arthur Linton, Corbin on Contracts* § 1045 (Interim ed.2002) (expressly stating that section 1045 addresses neither a contract right to interest nor statutory rights thereto, but only interest recoverable as compensatory damages for a breach of contract). In any event, the court ultimately applied Oregon's legal-rate-of-interest statute, which specifically provides that parties to a contract can agree to a higher rate of interest provided that such rate does not exceed the maximum rate allowed by law. See *id.*

**20** The court concedes at the outset that the cases relied upon by plaintiffs, to the extent those cases purport to stand for a well-recognized rule that parties are free to contract for an interest rate other than the rate established in section 1961(a), are problematic in certain respects. In large part, the cases offer very little analysis as to why parties would be able to contract around the seemingly mandatory language of section 1961(a). Moreover, in several of the cases, the precise issue was not one that the court had to decide and, thus, any conclusions about the issue would be mere dicta. Nonetheless, it is clear that the Seventh, Fifth and Ninth Circuits consider it beyond dispute that parties are free to contract for whatever post-judgment interest rate they choose. In addition, the Fourth Circuit, albeit in an unpublished decision, expressly adopted the Fifth Circuit's *Hymel* decision in affirming a district court's award of post-judgment interest at a rate set forth in a stock redemption agreement as opposed to the rate set forth in section 1961(a). See *Carolina Pizza Huts, Inc. v. Woodward*, 67 F.3d 294, 1995 WL 572902, at *3 (4th Cir.1995). Moreover, at least one district court has declined to award post-judgment interest at the section 1961(a) rate where the parties stipulated to the entry of a judgment which provided for interest at a higher rate. See *In re Connaught Properties, Inc.*, 176 B.R. 678, 684-85 (Bankr.D.Conn.1995).

In the end, the court is called upon to resolve a difficult legal issue on which the Tenth Circuit has not been called to opine-an issue that is rendered that much more difficult in light of the dearth of on-point analysis by other courts. After carefully weighing both sides of the issue, the court ultimately believes that the Tenth Circuit would likely concur with those Circuits that have held that parties should be and are able to contract for a rate other than the rate set forth in section 1961(a). While section 1961 without a doubt uses mandatory language, the court concludes that Congress intended it to be mandatory in the sense that a district court or other third party (e.g., an arbitrator) has no discretion to award a different rate of interest or to decline to award post-judgment interest. See, e.g., *Bell, Boyd & Lloyd v. Tapy*, 896 F.2d 1101, 1104 (7th Cir.1990) (section 1961(a) allows the judge no discretion to deny the interest authorized by that section); *Carte Blanche*, 888 F.2d at 269 (the language of section 1961 is mandatory and its terms do not permit the exercise of judicial discretion in its application). The court, however, can discern no sound reason why Congress would have intended that parties themselves could not agree to a different rate. Thus, the court rejects defendants' contention that section 1961(a) supersedes the rate agreed upon by the parties in the purchase agreement.

**B. Whether Plaintiffs Waived the Right to Assert the Contractually Agreed Rate**

**21 [27]** Defendants also oppose plaintiffs' motion to alter or amend on the grounds that plaintiffs waived the right to assert the 2% per month rate by failing to include that rate in the pretrial order. Plaintiffs concede that they did not articulate in the pretrial order their claim of entitlement to a higher rate of post-judgment interest. Nonetheless, plaintiffs contend that no such claim needed to be asserted in the pretrial order. As explained below, the court disagrees with plaintiffs on this point.

[28] In their papers, plaintiffs rely to a large extent on the legal principles that an award of post-judgment interest is mandatory, see *Bancamerica Commercial Corp. v. Mosher Steel of Kansas, Inc.*
and, as such, must be made regardless of what was demanded in the complaint or stated in the pretrial order. See Bell, Boyd & Lloyd v. Tapy, 896 F.2d 1101, 1104 (7th Cir.1990); 10 Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice and Procedure § 2664 at 186-87 (1998). However, the issue is not whether plaintiffs were required to request post-judgment interest in the pretrial order to receive an award of post-judgment interest. The law is clear (and defendants do not dispute) that plaintiffs are entitled to post-judgment interest, at least at the rate established in 28 U.S.C. § 1961(a), despite their failure to request such an award in the pretrial order. The issue as this court sees it is whether plaintiffs are entitled to an award of post-judgment interest at the higher rate of interest specified in the purchase agreement when no such request was made in the pretrial order.

It is axiomatic that a Rule 59(e) motion cannot be used to raise a new issue that could have been raised prior to judgment. See Steele v. Young, 11 F.3d 1518, 1520 n. 1 (10th Cir.1993); 11 Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice and Procedure § 2810.1 (2d ed.1995). In other words, Rule 59(e) is "aimed at re consideration, not initial consideration" and, thus, a party may not rely on Rule 59(e) to raise an argument which could, and should, have been made before judgment issued. United States ex rel. Noyes v. Kimberly Constr., Inc., 43 Fed.Appx. 283, 286-87 (10th Cir.2002) (emphasis in original). Despite plaintiffs' insistence that they did not need to raise the issue prior to judgment, 1276 it is beyond dispute that plaintiffs could have raised the issue prior to judgment. Unlike an award of postjudgment interest pursuant to 28 U.S.C. § 1961, the award sought by plaintiffs here was not necessarily a "given." In that regard, while defendants assert only legal arguments in opposition to plaintiffs' claim of entitlement to the higher rate of interest, it is possible that defendants could have sought to raise factual arguments in opposition to the claim. For example, defendants could have asserted that section 13.2(b) was altered by plaintiffs after the contract was signed. [FN13] Had defendants so asserted, then they would have been entitled to have the jury resolve that dispute. Because a court is not permitted to give relief under Rule 59(e) "if this would defeat a party's right to jury trial on an issue," see Wright, Miller & Kane, supra, § 2810.1, then the fact that one in the place of defendants might have had fact-based defenses available renders plaintiffs' request for award of postjudgment interest pursuant to the purchase agreement the type of request that cannot be raised for the first time pursuant to Rule 59(e).

No one, of course, is suggesting that plaintiffs did so; the court is simply posing a hypothetical for illustrative purposes to demonstrate that there might have been fact-based defenses available to defendants had the issue been raised by plaintiffs. Thus, because plaintiffs were not necessarily automatically entitled to the higher rate, the court rejects plaintiffs' contention that Federal Rule of Civil Procedure 54(c) requires an award of post-judgment interest at the higher rate irrespective of the contents of the pretrial order.

According to plaintiffs, defendants were nonetheless on notice that plaintiffs would assert a claim of entitlement to an award of postjudgment interest at the higher rate because defendants executed the purchase agreement and are charged with knowledge of the contents of that agreement. The court finds this argument disingenuous as it is clear that plaintiffs themselves did not remember (or perhaps even recognize) that the purchase agreement provided for a higher rate of interest until very late in the litigation process. Indeed, section 13.2(b) provides not only for postjudgment interest, but prejudgment interest-a remedy that plaintiffs failed to request at any time during the course of the litigation (and a remedy that plaintiffs acknowledge they cannot now seek). Plaintiffs' failure in that regard demonstrates to the court that they were not aware of or did not remember the contents of section 13.2(b). Moreover, while section 13.2(a) provides for a prevailing party to recover reasonable attorneys fees, plaintiffs did not assert a claim for fees in the pretrial order. This also demonstrates to the court the likelihood that plaintiffs had not considered the contents of section 13.2 in connection with this case at any time prior to entry of the pretrial order. Only after defendants asserted in the pretrial order a right to recover fees did plaintiffs scour the purchase agreement looking for the source of defendants' claim. At that point, after the entry of the pretrial order, plaintiffs moved to amend the pretrial order to assert a claim for fees. The court granted that motion because defendants, who had asserted a claim for the recovery of fees pursuant to the purchase agreement, were not prejudiced by the addition of that claim in that they clearly had knowledge of that portion of the contract and they had not demonstrated that plaintiffs' right to recover fees would affect the trial of the case in any way.
The court concludes that defendants were entitled to notice from plaintiffs prior to trial and, hopefully, at least by the date of entry of the final pretrial order that plaintiffs intended to seek postjudgment interest at the contractual rate. Such notice would have enabled defendants to ascertain whether they had any good faith factual arguments to raise in the face of section 13.2(b)-facultal arguments that could have been presented to the jury. Moreover, such notice would have permitted defendants to assess fully the risk of bringing this case to trial. More specifically, defendants would have been able to ascertain the total potential exposure that they might face if the jury, as they did, returned a verdict in favor of plaintiffs. Indeed, the interest rate set forth in the contract-2 percent per month-would expose defendants to an additional $600,000 per year in indebtedness to plaintiffs on a verdict of $2.5 million, assuming the jury's verdict is upheld on appeal. In short, the court believes that defendants were entitled to actual notice that plaintiffs' recovery might encompass this significant amount.

**23** In sum, plaintiffs' motion to alter or amend the judgment is denied to the extent plaintiffs seek an award of post-judgment interest pursuant to the interest rate set forth in the parties' purchase agreement.

C. Whether Delaware Law Prohibits Application of the Contractually Agreed Rate

Because the court denies plaintiffs' motion on the grounds that plaintiffs waived their right to assert the higher interest rate found in the purchase agreement, the court need not address defendants' argument that the higher rate is not permitted under Delaware law. Nonetheless, in the interest of judicial economy in the event the parties' appeal this court's decision to the Tenth Circuit, the court notes, without elaborating in full detail, that it would conclude that the higher rate established in the contract is permissible under Delaware law.

The Delaware law governing post-judgment interest is codified at section 2301 of Title 6 of the Delaware Code and states, in relevant part, as follows:

Any lender may charge and collect from a borrower interest at any rate agreed upon in writing not in excess of 5% over the Federal Reserve discount rate including any surcharge thereon, and judgments entered after May 13, 1980, shall bear interest at the rate in the contract sued upon. Where there is no expressed contract rate, the legal rate of interest shall be 5% over the Federal Reserve discount rate including any surcharge as of the time from which interest is due; provided, that where the time from which interest is due predates April 18, 1980, the legal rate shall remain as it was at such time.

Id. § 2301(a). The court agrees with defendants that section 2301(a) clearly provides that no interest rate can exceed 5% over the federal discount rate and rejects plaintiffs' argument that because the judgment in this case was entered after May 13, 1980, section 2301(a) permits interest to accrue at a contractually agreed rate.

However, as plaintiffs highlight in their papers, section 2301(c) expressly provides that there is "no limitation on the rate of interest which may be legally charged for the loan or use of money, where the amount of money loaned or used exceeds $100,000, and where repayment thereof is not secured by a mortgage against the principal residence of any borrower." While defendants urge that this provision does not apply because it is limited to the context of a unsecured loan between a lender and a borrower, section 2301(a) on its face would also appear to apply only to lenders and borrowers. Thus, if subsection (a) applies to the purchase agreement (as defendants urge that it does), then subsection (c) would have to apply as well. In any event, defendants are precluded under Delaware law from challenging the *1278 contractural rate as usurious. See Del.Code. tit. 6 § 2306 ("No corporation ... or limited liability company ... shall interpose the defense of usury in any action.").

For these reasons, the court would conclude that the rate of interest agreed upon by the parties in the purchase agreement is not prohibited by Delaware law.

III. Plaintiffs' Motion for Attorneys' Fees, Costs and Expenses

**24** The purchase agreement executed by the parties provides that the prevailing party shall be entitled to recover from the defaulting party all costs and expenses, including reasonable attorneys' fees, incurred in connection with enforcing the terms of the purchase agreement. See Purchase Agreement, Section 13.2(a) (Trial Exhibit 227a). Pursuant to this provision of the contract, and having prevailed on their breach of contract claim, plaintiffs Horizon and Mr. Pepper seek attorneys' fees and expenses totaling $846,740.35. [FN14] As set forth below, with the exception of a few minor adjustments, the court grants plaintiffs' motion. [FN15]
FN14. Plaintiffs' fee request covers the time period ending December 31, 2002. To the extent plaintiffs intend to recover fees, costs and expenses incurred in January 2003 in connection with responding to defendants' motion for judgment as a matter of law and filing their initial fee application, plaintiffs must file a motion for a supplemental award of fees, as those figures are not presently before the court. To the extent plaintiffs intend to seek fees in connection with defending an appeal filed by defendants, plaintiffs must direct such a request to the Tenth Circuit. See, e.g., San Juan Prods., Inc. v. San Juan Pools of Kansas, Inc., 849 F.2d 468, 477 (10th Cir.1988).

FN15. Because plaintiffs' fee request stems from a contractual fee provision, plaintiffs' request is subject to far less scrutiny than a request made pursuant to a fee-shifting statute and the court does not possess the same degree of equitable discretion to deny such fees as it has when applying a statute providing for a discretionary award. See United States ex rel. C.J.C., Inc. v. Western States Mechanical Contractors, Inc., 834 F.2d 1533, 1547-50 (10th Cir.1987) (remanding claim for attorneys' fees made pursuant to contractual fee provision where district court reduced the fee and, in doing so, applied the wrong standard and scrutinized the fee request too closely). In such cases, fees are "routinely awarded" unless the trial court determines that an award consistent with the request would be inequitable or unreasonable. Id. at 1548.

[31] The parties have stipulated to the reasonableness of all billing rates and, thus, the court need not address that issue. To the extent defendants do oppose plaintiffs' fee request, that opposition is both exceedingly narrow and easily resolved. Defendants assert that plaintiffs' request is simply too exorbitant because of the "limited success" achieved by plaintiffs at trial. To be clear, defendants have not articulated any objections to any specific portion of the fee request or plaintiffs' billing records and they do not contest any specific time entries. Instead, defendants assert only a general objection to the fee request as unreasonable. Indeed, in the face of a request for nearly $850,000 in fees and expenses, defendants have submitted a brief that is less than 9 pages in length.

[32][33] Defendants suggest in their papers that they are relieved of the burden of objecting to specific portions of plaintiffs' fee request because, according to defendants, plaintiffs have failed to meet their burden of showing that the request is reasonable. The court disagrees. To meet their burden of proving the number of hours reasonably spent on the litigation, plaintiffs "must submit meticulous, contemporaneous time records that reveal, for each lawyer for whom fees are sought, all hours for which compensation is requested and how those hours were allotted to specific tasks." *1279 United Phosphorus, Ltd. v. Midland Fumigant, Inc., 205 F.3d 1219, 1233 (10th Cir.2000) (citing Case v. Unified Sch. Dist. No. 233, 157 F.3d 1243, 1249-50 (10th Cir.1998)). The district court, then, may reduce the number of hours when the time records provided to the court are inadequate. Id. at 1233-34. The court has reviewed the billing records submitted by plaintiffs and those records are more than adequate to meet plaintiffs' burden.

[34][35] Defendants also invite the court to dissect plaintiffs' billing records in an effort to determine or "approximate" those fees that are attributable to the breach of contract claim and those fees that are attributable to the unsuccessful claims. The court, however, is not obligated to comb the record to ferret out deficiencies in plaintiffs' submission. It is defendants' obligation to direct the court to such deficiencies if they believe such deficiencies exist. See Public Serv. Co. of Colorado v. Continental casualty Co., 26 F.3d 1508, 1521 (10th Cir.1994) ("We do not feel that the trial judge was obligated to comb the evidence before him-consisting of voluminous attorney billing records-to ferret out gaps or inconsistencies in the evidence presented on the fees."); see also United States ex rel. C.J.C., Inc. v. Western States Mechanical Contractors, Inc., 834 F.2d 1533, 1549 (10th Cir.1987) ("[T]he trial court is not responsible for independently calculating a 'reasonable' fee."). Nonetheless, the court has reviewed the billing records and, in large part, concludes that plaintiffs' fee request is a reasonable one. The court will, however, deduct from plaintiffs' request fees of $67.50 for work performed by attorney Normal Siegel on April 15, 2002 and fees of $585.00 for work performed by attorney Amy Baumann on August 14, 2002. It is apparent from plaintiffs' papers that they intended to deduct these fees from their request (and to request fees for attorney time only to the extent work was done by the two primary lawyers involved in the case-George Hanson and Todd McGuire) but, presumably by
oversight, neglected to do so. Similarly, the court will deduct fees of $3195.00 incurred during July 2002 in connection with plaintiffs' motion to compel discovery. Again, plaintiffs' papers indicate that they intended to deduct these fees from their request, having already recovered this sum from defendants by virtue of this court's July 25, 2002 order, but the billing records indicate that this deduction was not, in fact, made.

**25 To reiterate, then, aside from these minor deductions, the court has reviewed the billing records and, in the absence of any specific objection to plaintiffs' request and in the absence of any evidence that the hours claimed by plaintiffs are unreasonable, concludes that plaintiffs' fee request is a reasonable one. See Robinson v. City of Edmond, 160 F.3d 1275, 1279, 1285-86 (10th Cir.1998) (plaintiffs requested $186,000 in fees and defendants generally objected to this request as unreasonable but specifically articulated objections to only $43,000 of the request, leaving $142,000 in requested attorney's fees "not separately contested;" district court abused its discretion in reducing fee award in part because the end result was a fee award that was below the "unrebutted," "unchallenged," and "uncontested" amount of the fee request); Sheets v. Salt Lake County, 45 F.3d 1383 (10th Cir.1995) (affirming trial court's fee award in part because defendants failed to proffer any evidence that the hours claimed were unreasonable and, instead, simply made unsubstantiated allegations that the fees were duplicative and exorbitant in nature).

Defendants' general objection to plaintiffs' request is that the request is simply unreasonable in light of plaintiffs' "limited success"—plaintiffs prevailed only on their "relatively simple" contract claim. In the context of this litigation, however, a verdict *1280 of $2.5 million is a substantial victory for plaintiffs and there was nothing "simple" about the contract claim. Rather, the case presented complex commercial issues and plaintiffs' counsel successfully developed those issues at trial. Indeed, Mr. Pepper and Horizon's breach of contract claim—the claim on which plaintiffs ultimately succeeded—encompassed a claim that defendants had breached the implied covenant of good faith and fair dealing, a claim that is often difficult for judges and lawyers to comprehend let alone lay persons on a jury. To prove plaintiffs' claim at trial, plaintiffs' counsel could not rely on an express term of the contract and could not point to one specific act that constituted defendants' breach. Instead, counsel was required to convey to the jury that defendants' entire course of conduct (conduct that spanned over 18 months) breached an "implied" duty to act in "good faith." Despite the sheer volume of evidence needed to describe and place in context defendants' course of conduct, coupled with the need to fit that evidence into amorphous concepts like "good faith" and "implied duty," plaintiffs' counsel achieved a multimillion dollar verdict for his clients. For these reasons, the court readily concludes (and defendants cannot seriously dispute) that plaintiffs obtained excellent results at trial. See Hampton v. Dillard Dept. Stores, Inc., 247 F.3d 1091, 1120 (10th Cir.2001) (proper focus is on the overall relief obtained). No blanket reduction is warranted and plaintiffs' counsel is deserving of a fully compensatory fee. See Hensley v. Eckerhart, 461 U.S. 424, 433-35, 103 S.Ct. 1933, 76 L.Ed.2d 40 (1983).

**26 [36] In a related vein, defendants contend that plaintiffs are only permitted to recover those reasonable fees and expenses incurred in connection with the pursuit of their contract claim. Defendants contend that plaintiffs are improperly attempting to recover fees and expenses associated with the numerous claims on which plaintiffs did not prevail at trial and that the time and labor required to present evidence to the jury that defendants breached the purchase agreement was "only a small part of that actually expended by plaintiffs' counsel." The court rejects this argument, too. As an initial matter, plaintiffs' papers demonstrate that plaintiffs' counsel have already excluded from their request those hours associated with discrete research and other work related to plaintiffs' statutory discrimination claims, including hours spent working with plaintiffs' expert witness concerning plaintiffs' potential damages under Title VII. See Robinson, 160 F.3d at 1281 (prevailing party must make a good faith effort to exclude from request those hours that are excessive, redundant or otherwise unnecessary).

[37] In any event, in light of the fact that most, if not all, of the unsuccessful claims were intertwined with the successful breach of contract claim through a common core of fact or related legal theories, any reduction of fees would be inappropriate. See id. at 1283 (reversing district court's reduction of fee award on the grounds that plaintiffs achieved only partial success where all unsuccessful claims were intertwined with the successful claims). The law is clear that when a lawsuit consists of related claims, a plaintiff who has won substantial relief should not have his attorney's fee reduced simply because the court or jury did not adopt each contention raised. See Hampton, 247 F.3d at 1120 (citing Jane L. v. Bangerter, 61 F.3d 1505, 1512 (10th Cir.1995)).
Utilizing this standard (a standard that defendants do not even reference in their papers), the court simply cannot conclude that any of plaintiffs' unsuccessful claims are unrelated to the pursuit of the ultimate result achieved. Indeed, any attempt to divide the hours expended in this case on a claim-by-claim basis would be difficult and unjust. Nearly all of the claims pursued by plaintiffs-particularly plaintiffs' fraud and breach of contract claims-centered on the same core of facts. Any investigation or development of the fraud claim would necessarily have encompassed plaintiffs' breach of contract claim (and vice versa) as both claims required careful scrutiny of the parties' pre-contractual negotiations and the parties' conduct throughout the course of the contractual relationship. Thus, it is not surprising to this court that the billing records of plaintiffs' counsel, in large part, do not distinguish between claims. See id. at 435, 103 S.Ct. 1933 ("Much of counsel's time will be devoted generally to the litigation as a whole, making it difficult to divide the hours expended on a claim-by-claim basis.").

Moreover, the Tenth Circuit has emphasized the importance of allowing litigants the "breathing room" necessary to raise alternative legal grounds that seek the same result and, thus, focusing on the actual result of the trial rather than dividing attorneys' fees by the number of successful claims. See Robinson, 160 F.3d at 1283.

**27 For the foregoing reasons, the court rejects defendants' contention that a blanket reduction of fees is warranted and, with the exception of the minor adjustments noted above, grants plaintiffs' motion for fees and costs and expenses.

IT IS THEREFORE ORDERED BY THE COURT THAT plaintiffs' motion to alter or amend the judgment (doc. # 197) is granted in part and denied in part. Specifically, the motion is granted to the extent that a typographical error in the judgment shall be corrected and is otherwise denied; plaintiffs' motion for attorneys' fees, costs and expenses (doc. # 198) is granted in part and denied in part and the court awards plaintiffs fees, costs and expenses in the amount of $842,892.85; and defendants' renewed motion for judgment as a matter of law pursuant to Rule 50(b) or, in the alternative, motion for remittitur and/or new trial pursuant to Rule 59 (doc. # 199) is denied.

IT IS FURTHER ORDERED BY THE COURT THAT the clerk of the court shall amend the judgment to reflect this court's award of $842,892.85 in attorneys' fees, costs and expenses. The amended judgment should also be corrected to reflect that the jury returned a verdict on November 21, 2002 as opposed to November 12, 2002.

IT IS SO ORDERED.

244 F.Supp.2d 1250, 2003 WL 355664 (D.Kan.)

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EARNOUTS: AN OUTLINE OF KEY ISSUES

MARK D. GERSTEIN

Special thanks to Chunlin Leonhard of Latham & Watkins, for her assistance in the preparation of this outline, and Fred Mardell, former Vice-Chairman of Barton Brands, Ltd., for his review and commentary.
Introduction

Well crafted and carefully thought through, the earnout is often an effective device for addressing legitimate differences between the Purchaser and Seller as to the prospective value of a Target company or to incentivize management to successfully transition ownership and maintain or build post-closing value.

When drafted without sufficient client input or foresight, an earnout can become difficult to interpret, hamstring a Purchaser’s efforts to reorient or restructure the Target, misappropriate future value to the wrong party or motivate the earnout’s recipients to focus on short-term goals which will personally reward them, but will have adverse long-term consequences for the Target.

Because each transaction is unique, it is impossible to draft an earnout that will apply to the contingencies of every situation; any attempt to do so will most likely result in a provision that falls into the latter category of earnouts noted above. Accordingly, this paper highlights those situations in which an earnout or other form of contingent payment may be useful, outlines the general terms governing the structure of earnouts, flags issues that purchasers and sellers need to address in drafting earnouts and gives brief consideration to tax matters affecting earnouts.

I. Circumstances in which Earnouts are Often Useful

A. Where Seller and Purchaser disagree over projected earnings or other indicia of value for the Target.

1. New Products - Particularly in the strategic buyer driven mid-90s, acquisitions are often motivated by efforts to acquire new product lines or capture matured research and development. The valuation of these assets is often based solely upon projections, where Purchaser and Seller may have legitimate differences as to volume, pricing and even market acceptance. By properly structuring an earnout, Purchaser and Seller can capture this future value without placing the risk of erroneous valuation assumptions in a prospective valuation.

2. Turnaround - As historical financial information is often unhelpful in evaluating the pricing for a turnaround acquisition, an earnout that bases a portion of the valuation on actual future performance can enable Seller and
3. Industry Trends - Differences in valuation may also be a consequence of differing analyses of macroeconomic matters, such as general terms of the economy or trends within the Target’s industry. Earnouts can bridge the gap between these differing assumptions.

B. As an incentive to present management/owners to maintain and increase profitability post-closing - Particularly in “people-driven companies,” such as software development and service firms, an earnout is often a mechanism of inducing management to make a smooth transition and to maximize profit notwithstanding their diminished or eliminated ownership position in the Target. The technique does not differ substantially from other incentive programs, except that the financial compensation may represent, in part, value existing in the business prior to closing which management may only retain by meeting performance goals.

C. To simply bridge unrealistic expectations of Seller - Something like the brass ring on a merry-go-round, this type of earnout is based upon benchmarks and targets that the Target is unlikely ever to achieve. Nonetheless, the recitation of the potential future payment may be enough to appease the unrealistic Seller and close the deal.

II. Earnout Structures

A. “Earnings” Indicator

1. Gross Revenues or Sales - This indicator is infrequently used, and only where cost of goods sold and SG&A have little variability. One potential pitfall for the Purchaser is, most notably, a lack of incentive for ongoing managers/former owners to control expenses. Further, where profitability is measured on a long-term basis, such as in connection with finance companies where the initial booking of the loan is not the long-term measure of the profitability of the asset, this type of earnout can encourage the recipient to book sales which achieve near-term benefits to the recipient through the earnout, but in the long run may
be only marginally profitable or present substantial risks for the Purchaser.

1. **Net Income** - Net income is probably the most commonly used indicator of post-closing success of a business, product or segment. It is most attractive to purchasers in that it measures profitability ultimately in the same way that the Purchaser will for internal purposes. For the Seller, an indicator which is reduced by interest, taxes, depreciation and amortization will often create a distortion between pre- and post-closing operations and capital structure, often severely penalizing the Seller’s earnout payments (see § III.B. below).

2. **EBITDA or EBIT** - More desirable from the Seller’s perspective, this indicator avoids some of the issues noted above and, where the earnout is, in essence, a deferred purchase price based upon a multiple of the post-closing EBITDA, it fits into the paradigm of most valuation models. From the Buyer’s perspective, post-closing interest expense related to working capital and historic depreciation are relevant to the ultimate profitability of the business to the Purchaser; accordingly, where the earnout represents a percentage of profitability as opposed to a post-closing revaluation of the business, EBITDA may be an inappropriate indicator and EBIT may be utilized. An EBIT measure must address the concerns noted in § III.B, particularly amortization of acquisition related goodwill and expenses.

**B. Source**

1. **Entire Target** - Used most often where the earnout represents differences in the valuation of the Target due to broad issues, such as macroeconomic conditions or expectations for the Target’s overall future prospects. Also used where earnout is an incentive for the former owners/management to transition ownership and remain “invested” in the enterprise.

2. **Product Specific** - Utilized where prospective valuation differences are tied to new product or segment.
for this source is often gross revenues, sales or EBITDA, as allocation of costs of capital structure and SG&A are often difficult.

3. Division Specific - Same rationale as B.1 above, and is often utilized where there is a substantial likelihood that the Purchaser may dispose of the division post-closing and the Seller has been unable to capture the future value of that sale in the initial purchase price.

4. Blended among entities - Somewhat of a nightmare in terms of drafting, this form of earnout reflects the existence of an overlap in products or segments between the Purchaser and the Target. The blended measure is intended to ensure that sales are not shifted artificially by the Purchaser from the Target to the Purchaser’s affiliates and, similarly, to protect the Purchaser if there are substantial efficiencies in moving sales from the Purchaser to the Target, which the Purchaser does not intend for the Seller to capture in an earnout payment.

C. Termination Provisions

1. Temporal - The most common termination mechanism for an earnout is temporal, that is, an amount of time has passed (i) which the parties have agreed is a sufficient measure of the projected value of the product segment or business, or (ii) is the period during which the Purchaser intends to incentivize the former owners/managers. Temporal earnouts are often associated with the exit described in C.3. below.

2. Event Specific - The specific events which may result in termination and payment of an earnout are deal specific and dependent on the purpose of the earnout. Examples of events which often trigger payment and termination include sale of the subject business/division/segment, change in control of the Purchaser (often a creditor protection device for the Seller) or termination of the recipient’s employment. See Appendix B, Section 2.13, for a sample acceleration provision.
3. **Purchaser’s Option** - Because earnouts may affect the flexibility of post-closing operation of the Target, and few subsequent purchasers of a business will accept assets burdened by an earnout, it is usually valuable to the Purchaser to have a buyout option for the earnout, which is often based on a multiple of historic payments or, where an earnout is intended to reflect a post-closing valuation of the business, based upon expert valuations, such as those of investment bankers. While often a source of difficult and frustrating negotiations, this aspect of the earnout has often proved to be the most crucial term negotiated as (notwithstanding careful drafting) unintended and unnecessary consequences of earnouts often arise; the buyout option limits the “holdout” value of a Seller when approached in such circumstances to resolve the difficulty presented by the earnout.

4. **“Exit Kickback”** - A sure sign of a strong Seller’s market, the “exit kickback” is essentially a “tail” on the sale in the event the Buyer achieves a “quick flip” success. Recently being sought from financial buyers, it has not become a general request and is not a true “earnout” in the sense that it has little to do with the Seller’s post-closing efforts or the Target’s post-closing operations.

D. **Value of the Earnout** - Once the source and indicator of the earnout are established, it must be determined how the earnout payment will be tied to the indicator. While the ultimate percentage or multiple is a purely business issue, whether the payment is a multiple or percentage does, to some extent, reflect the reasons the earnout was introduced to the transaction.

1. **Percentage of Indicator** - Used more commonly where the earnout is intended to be an incentive for management, as opposed to reflecting a delayed payment for value arising out of differing assumptions of the Purchaser and the Seller. A percentage is also sometimes used where the payment is intended simply to accommodate expectations of the Seller by creating a potentially large dollar amount which the Purchaser, if the company were to realize the benchmark, is prepared to pay in order to close the transaction.
2. Multiple of Indicator - *This method of calculating the payment is most often utilized to value the portion of the business as to which differing assumptions or expectations existed, e.g., 5 x post-closing EBITDA.*

3. Lump Sum Versus Sliding Scale - *An often difficult part of negotiating an earnout will be whether payments are prorated if the benchmarks or goals are only partially achieved, or instead the benchmark is a hurdle for payment. There is no strong theoretical basis for either position; rather, it is simply a matter of negotiating leverage. Often the Seller and the Purchaser will resolve the negotiation by establishing a minimum hurdle before any payment will be made and allow a sliding scale or proration after that hurdle is achieved.*

E. Method of Payment

1. Contract Right - *The most common form of earnout, the right to payment is established in the Purchase Agreement itself and is a contract right.*

2. Non-Cash Consideration - *Stock of the Purchaser can be used as the currency of payment.*

3. Alphabet Stock - *If multiple Sellers are involved, or even a public shareholder group is selling, a separate class of stock representing the earnout may be established. On a much more general basis, this is essentially the theory embodied in the alphabet stock issued by GM in its acquisitions of Hughes, EDS and others.*

4. Special Partnership Interest - *Similar to alphabet stock, the partnership interest receives payment only in the event that the earnout objectives are achieved. In some circumstances, this form of earnout can be utilized to create only one level of taxation; that is, the income which is the source of the earnout calculation will not be taxed before taxation is imposed upon the payment received by the earnout recipient. This is not an easy goal to accomplish, but it should be considered in appropriate circumstances.*
5. Mix of Consideration - The concerns noted below (§ V.C) as to an earnout focusing the recipients on short term and provincial goals rather than long term issues that benefit the overall profitability of Target and Purchaser can be mitigated by paying a portion of the initial purchase consideration or the earnout in stock of Target or Purchaser.

6. Subordination issues - Lenders will often consider the recipient of an earnout an equity holder and seek to subordinate the payment to the lender’s unsecured obligations, including by seeking to limit the amount of the payments made while the lender’s debt is outstanding. This issue should be anticipated early on in the negotiations and the Seller should always advise the Purchaser that such a position will be unacceptable and should be presented as such to lenders early in the financing commitment process.

7. Escrow - To preserve a pooling transaction, it may be feasible to escrow stock which will be released if the earnings targets are met.

8. Enhancement - Credit enhancement may be provided to insure or support payment of the earnout. See Appendix B, Section 2.12.

III. Issues for the Seller

A. Consistent Accounting Methodology Prior and Post-Sale - As experienced counsel knows, the term “GAAP” represents a range of potential accounting positions upon which even a Texan could feel comfortable. As a consequence, the ability to manipulate the results of an earnout through adjustments to GAAP is often legitimately of great concern to the Seller and must be controlled. Potential areas for variation include inventory valuation methods (not only LIFO versus FIFO, but the manner of treating inventory as obsolete), depreciation schedules, accounting for retirement and welfare benefits and reserves for bad debts. To address these concerns, in addition to the customary covenants regarding continued application of GAAP as applied by the Seller prior to closing, the Seller may wish, as to certain matters that are of heightened
concern or specific to the Target’s industry, to specifically set forth the methodology of accounting treatment.

In addition, changes in GAAP promulgated by the FASB post-closing should not affect the determination of the earnout. By way of example, consider the effects upon an earnout of the FASB’s requirements regarding treatment of post-retirement medical liabilities in a transaction which closed prior to the standards being adopted or applied.

B. Transaction Related Charges and Adjustments For Changes in Capital Structure - Although the calculation of an earnout based on EBITDA will address most concerns arising out of post-closing modifications of the Target’s capital structure, where EBITDA is not utilized and in certain other circumstances, the following issues should be carefully considered.

1. Transaction Related Charges - While most acquisition related charges will be accrued pre-closing, some charges may be first booked after closing or, more likely, may be capitalized and charged against the earnings upon which the earnout may be measured.

2. Goodwill Amortization - Amortization of goodwill arising out of the acquisition of the Target should clearly be excluded from post-closing measures of net earnings. Amortization arising out of subsequent acquisitions undertaken through the Target by the Purchaser should similarly be excluded.

3. Increased Depreciation From Step Up In Basis Or Changes In Methodology- In asset purchase transactions, the step-up in basis of the assets of Target will increase depreciation charges, which might adversely affect the earnout for the Seller. Similarly, changes in depreciation schedules either at the election of the Purchaser or due to subsequent changes in GAAP may also affect earnout calculation.

4. Acquisition Indebtedness/Other Indebtedness - In addition to the obvious adverse impact of the interest component upon an earnout calculation, fees and expenses associated with financings or a prepayment should also be excluded from the
calculation of the earnout. It is important to make certain that the exclusions which cover the initial acquisition indebtedness cover subsequent refinancings of that indebtedness.

5. Intercompany Indebtedness - Concerns here are similar to those noted in Item 4 above.

C. Corporate Allocations

1. Central Office Overhead

a. Legal and other G & A - Allocations of corporate headquarters’ expenses and services amongst affiliated groups is often haphazard at best and charges may or may not include a “profit” component for the parent company. Care should be taken in excluding charges other than those which have been requested by the Target and which are priced on an arms-length basis.

b. Executive Compensation - Similar to the charges for legal and other G&A, executive compensation is sometimes allocated amongst members of the affiliated group, or new officers are appointed to the Target whose compensation is directly charged to the Target. Often the Seller will accurately consider such appointments to be nothing more than a reallocation of overhead to Target, which should be excluded from the earnout calculation.

c. Corporate Charge or Management Fees - It is not uncommon, particularly in the case where indentures or bank documents prohibit distributions to a parent company or its affiliates, to have management contracts or service agreements which provide for the payment of fees directly to the corporate parent or its affiliates. Because these charges are often more appropriately characterized as distributions of profits, in such cases they should not be treated as an expense item when calculating the earnout.
2. Employee Welfare and Pension Benefits - *In an affiliated group* where pension and employee welfare liabilities are funded through a master trust or similar arrangement, the allocation of charges amongst affiliated companies may be based more upon “who has the ability to pay” than upon the actual per capita cost of the benefits.

3. Tax Sharing Agreements With New Parent - *Often the Target will become part of the Purchaser’s consolidated tax reporting group.* Care should be taken to ensure that the definition of taxes (in a transaction which is based upon EBITDA) includes payments made under tax sharing arrangements, which might otherwise be expensed against earnings. To the extent an earnout is based upon an after-tax indicator, care should be taken as to how taxes are allocated amongst members of the affiliated group. Further, some tax-sharing agreements with a leveraged parent company provide for payments to the parent by subsidiary members of the consolidated group in consideration of the overall reduction in taxes achieved through the sharing of the holding company’s tax losses with the affiliated group; such allocations should be carefully scrutinized.

4. Insurance - The costs of insurance purchased by the parent company which covers all of its subsidiaries is often allocated amongst subsidiaries. The earnout should contain language that provides for allocation on a basis reasonably related to the market costs of the policies, and without any profit to the parent.

D. Operation of Target Post-Closing

1. Consistent Operations - This issue strikes at the heart of why most draft earnouts do not make it into the final agreement. Unless the Purchaser is prepared to afford substantial latitude regarding control of the Target to the surviving management team which are recipients of the earnout, substantial anxiety and debate will arise over the ability of the Purchaser to reduce the value of the earnout either intentionally or unintentionally through mismanagement or redirection of the Target’s operations. The parties will often seek to address this issue with general language regarding
“continued operation of business as conducted prior to closing,” but such language, absent intentional misconduct on the part of the Purchaser, would likely be difficult to enforce.

2. Adequate Capital - An often overlooked concern in drafting the parameters of operations of the Target post-closing is the Purchaser’s assuring provision of capital adequate for existing operations as well as projected expansion. This concern extend both to working capital and the funding of hard capital needs, such as equipment purchases.

3. Exploitation of Opportunities - The projections upon which the targets for the earnout are based will often depend upon the exploitation of opportunities, whether existing product lines, growing market segments or sales in new territories. To the extent such exploitation is a principal assumption of the earnout targets (or the Seller’s expectations for receiving the earnout), specific requirements or soft language reflecting the intent of the parties as to such matters should be included in the earnout provisions.

4. Dispositions of Products/Segments - While producing one-time gain which may benefit the earnout in a single period, dispositions of products or segments which were an essential premise of the earnout targets can undercut, if not eviscerate, the Seller’s ability to achieve the earnout. One mechanism for addressing such a sale is to project the historic income of the product/segment which was disposed of over the remaining periods of the earnout. See Appendix B. Section 2.1(B) for an example provision. Alternatively, the Seller may demand a portion of the profit on the sale. See § II. C.4.

5. Extraordinary Items - Extraordinary charges, ranging from casualties, gain or loss on dispositions, and the like should be excluded from the earnout calculation.

6. Capital Expenditures - Substantial increases in capital expenditures may increase interest and depreciation charges and adversely affect a net income based earnout, particularly in the event that there is substantial lag time
between the recognition of income generated by the assets which have been acquired and the period(s) in which the cost of such acquisitions are accrued.

IV. Issues for the Purchaser

A. Necessity of Buyout/Termination Mechanism - See § II.C.3 above.

B. Structuring Protections for the Seller without Unduly Interfering with Flexibility of Operation of Target Post-Closing - Unless it is operationally acceptable to the Purchaser, that is, the Purchaser intends to provide substantial latitude to existing management in the operation of Target post-closing, it is generally unwise to structure protections for the Seller against concerns such as those noted above by obligating the Purchaser/Target to covenants regarding the operation of the business. If structured through covenants, the earnout protections are likely to substantially limit the Purchaser’s ability to modify, expand or contract the Target’s operations or capital structure. Instead, earnouts should generally be drafted in the form of mandated accounting treatment of certain items, such as:

“expenses associated with capital expenditures in excess of the average capital expenditures of the Target during the three-year period preceding closing shall be excluded from the calculation of net income” instead of

“Target shall not undertake capital expenditures in excess of the average amount of capital expenditures in the three-year period preceding closing.”

C. Giving Away Synergies To Seller - Increases in EBITDA or net income may result from the efforts of the Purchaser, rather than the former owners, whether through management skill or synergies arising out of the simple combination of the operations (such as reductions in sales costs, administrative charges and the like). If the earnout is intended to reward post-closing efforts of the former owners or better define value which the parties were unable to agree upon prior to closing, in the best of all possible worlds the
Purchaser would exclude these benefits from the earnout calculation. In practice, it is difficult to find a way to calculate or even carefully describe growth in revenues, or reduction in expenses to which the Seller is not contributing. In some circumstances, however, there may be easily identifiable savings, such as reductions in overhead or personnel costs, which are calculable or may be described with relative clarity in an agreement, so that the financial contribution of those savings are not included in the calculation of the earnout indicator. See Appendix B Section 2.1(C). where the synergy was allocated to Seller.

D. Unanticipated Growth Or Diversification In The Target - Particularly if the Purchaser intends to use the Target as a platform for future acquisitions, income or cash flow arising out of such acquisitions or expansion may need to be excluded from the earnout calculation.

E. Converse Of Seller’s Issues - Many of the issues outlined above in Section III as issues for the Seller present complementary concerns for the Purchaser. By way of example, changes in accounting methodology which might be undertaken by the Purchaser in order to provide consistent accounting treatment among affiliated companies might artificially boost earnings and should be excluded from the earnout; similarly, pension benefits may be consolidated in a master plan which, if overfunded, may reduce the charge to earnings for the Target for funding pension obligations.

V. Shared Concerns of Seller and Purchaser

A. Overlap of Products/Segments in Target and Purchaser or Its Affiliates - Acquisitions driven by strategic buyers often seek to realize benefits from the consolidation of sales forces, manufacturing facilities, distribution systems and the like. A natural consequence of these consolidations may be to shift sales from Target to Purchaser, or vice versa, in an effort to achieve intelligent operational synergies. Nonetheless, such shifts will distort the indicator for the earnout and must be anticipated in drafting.

B. Accounting and Audit Matters - Mechanisms for calculation of the earnout indicator and appropriate adjustments should be carefully delineated in the Purchase Agreement, as well as an arbitration mechanism for resolving disputes. Customarily, one of the parties’
accountants, usually the Purchaser’s, is charged with initially calculating the earnout, and a challenge and arbitration process is established for the benefit of the Seller.

C. Distorted Incentives - It is impossible to understate the amount of attention which should be addressed by counsel and business personnel to the potential for the earnout to shift the attention of the recipients of the earnout from long-term objectives to short-term targets which support or increase the earnout but which are inconsistent with the long-range prospects or objectives of the Target. By way of example, an earnout tied to loan production at a finance company during the years following closing may incent the recipients of the earnout to book loans regardless of, or with an inappropriately low level of attention to, the long-term quality of the credit. Similarly, where the long-term potential of a product is dependent upon consistent support for the brand through advertising and other support, an earnout based on net income may incent the former owners to substantially reduce outlays for advertising and the like with the intent of boosting near-term profits, but with disastrous long-term consequences for the brand.

D. Shifting of Income - Earnouts based on year-to-year performance, that is, which make periodic payments based upon interim results, can result in distorted payments arising out of unexpected timing of income or losses and may tempt either Purchaser or the recipients of the earnout to move income or expenses from one period to the other in order to distort the earnout indicator. Even with respect to earnouts based on an extended period of time, this temptation exists in the final period of the earnout, that is, shifting expenses (in the case of the recipients) or income (in the case of the Purchaser) to the period following the earnout. See Appendix A, Sections 9.1(b)(vi–vii).

VI. Tax Matters

A. Types of Agreements.

1. Escrow Earnout - In a typical escrow agreement, either Purchaser or Target deposit into escrow at the time of the sale or reorganization, an agreed number of Purchaser shares. If the Target shareholders have the right to vote and/or the right to receive dividends, they will probably be
considered to be the owners of the shares for federal income tax purposes from the date of issue.

2. Contingent Stock - In a typical contingent stock agreement, Purchaser must issue additional stock to Target’s shareholders at a future date subject to the happening of the contingency. Since these shares have not yet been issued, Target’s shareholders should not be considered the owners for Federal income tax purposes until the stock is actually issued.

3. Contract Right or Contingent Debt - Purchaser may issue a contract right or other contingent debt instrument to the Sellers (referred to herein collectively as “contingent debt”). This arrangement will generally allow Purchaser to deduct the portion of the contingent return on the debt as interest, and the Target holder of the debt will have to include this amount as ordinary income rather than capital gain on the sale. However, contingent debt is subject to a number of complex, and sometimes conflicting tax rules, that specify, among other things, when the interest must be recognized by the holder, and consequently, when Purchaser may deduct it. It should be noted that these recognition and deduction rules may override the taxpayer’s normal method of accounting.

B. Earnouts in a Tax-Free Reorganization.

1. Is an Earnout Boot - The rules for some types of tax-free reorganizations limit or even deny the use of property other than Purchaser stock (or stock of a corporation that controls Purchaser) as consideration in the transaction. This type of property is commonly referred to as “boot.” The use of too much boot in a reorganization may destroy the tax-free status of the reorganization.

2. Escrow or Contingent Stock - Generally, the use of escrowed stock will not result in boot. However, a contingent stock arrangement may result in boot depending on its terms. Generally, a contingent stock arrangement does not produce boot as long as the contingent stock arrangement provides that the Target shareholders will not receive any interest or dividends on the contingent stock.
3. Contingent Debt. The issuance of Contingent Debt will generally be treated as boot.

C. Imputed Interest on the Earnout.¹

A portion of the earnout, whether it is payable in cash or additional stock, may be characterized as imputed interest for Federal income tax purposes. Accordingly, Purchaser will be entitled to deduct the interest, and Target’s shareholders must include it in their income as ordinary income rather than capital gains. Thus, the timing of the deduction and inclusion are significant to all of the parties. There are a set of very complex, and sometimes conflicting tax rules that govern this timing, and which may produce different results depending upon various factors such as:

1. Whether the earnout is a debt instrument for Federal income tax purposes, and if so, whether the debt instrument is publicly traded.

2. Whether the earnout is issued at a discount, par, or at a premium.

3. Whether the earnout will be paid in publicly traded stock.

4. Whether Purchaser, Target, or Target’s shareholders are related for Federal income tax purposes.

D. Earnouts and S Corporations.

Query whether an earnout may result in a second class of stock in an S corporation?

VII. Earnouts in the Public Company Context

A. Broad Groups of Holders - Earnout and similar contingent payment mechanisms can also be utilized as consideration to be provided to a broad group of holders, including the selling stockholders of a public company.

¹ This section assumes that the payout will occur in a tax year after the closing occurs.
B. Unique Issues - The issues associated with establishing such a “public earnout” are predominantly the same as those discussed above in the private company context. However, certain issues are unique to this context, based principally upon the number of holders receiving the right to the earnout payment.

1. Payment Mechanism. To minimize recordkeeping obligations for the acquiring party and to facilitate timely payments, a paying agent may be employed. This bank or other institution will keep track of addresses or accounts for payment, make appropriate tax filings and disburse payments when received from the acquiring party.

2. Transferability. In an apparent effort to avoid characterization of the earnout right as a “security” subject to registration under federal and/or state securities laws, the earnout right is structured so that it is not transferable (except by laws of descent and distribution), and is explicitly referenced not to be a form of equity or security, but instead only a “contractual right.” Whether these limitations and self-serving declarations are sufficient to avoid registration under the Securities Act of 1933 is unclear. Further, this limited transferability is likely to affect the value ascribed to these rights and the entire transaction by an investment bank providing an opinion as to the overall fairness of the transaction, as well as by stockholders whose vote or tender may be required to approve or effect the transaction.

3. Dispute Resolution. In light of the large number of holders of the earnout right, the ability to resolve disputes should be delegated by the recipients of the earnout right to a single representative, who is authorized by the documentation establishing the earnout to initiate, pursue and settle disputes with the acquiring party. Although not technically an indenture trustee, in structuring the relationship between this agent and the earnout recipient, one may wish to look to this regime, particularly the rights of holders to initiate disputes without the agent’s consent and to direct the agent’s actions.

4. Currency for Payment. As with a private earnout, cash or stock may be issued in satisfaction of the earnout right; however, the latter may further complicate the analysis of
whether the earnout is a security subject to registration under the Securities Act.

VIII. Examples

Appendix A - Earnout based upon percentage of net income with termination option for purchaser

Appendix B - Complex adjustments to GAAP; acceleration events; credit enhancement; treatment of disposition of product line subject to earnout.

Appendix C - Examples of “public” earnouts.
APPENDIX A

9.1 Additional Consideration

(a) As additional consideration for the Transferred Assets, Purchaser shall pay to the Company an amount (the “Additional Consideration”) equal to the percentage of “Purchaser’s Net Income” (as hereinafter defined) set forth below for each of the applicable periods (each, a “Contract Period”):

<table>
<thead>
<tr>
<th>CONTRACT PERIOD</th>
<th>PERCENTAGE OF PURCHASER’S NET INCOME FOR SUCH PERIOD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funding Date</td>
<td>12/31/1990 70%</td>
</tr>
<tr>
<td>1/1/1991</td>
<td>12/31/1991 60%</td>
</tr>
<tr>
<td>1/1/1992</td>
<td>12/31/1992 60%</td>
</tr>
<tr>
<td>1/1/1993</td>
<td>12/31/1993 60%</td>
</tr>
<tr>
<td>1/1/1994</td>
<td>12/31/1994 60%</td>
</tr>
<tr>
<td>1/1/1995</td>
<td>12/31/1995 120%</td>
</tr>
</tbody>
</table>

Payments by Purchaser to the Company of Additional Consideration under this Section 9.1(a) shall be made on the 30th business day after receipt by Purchaser of its audited financial statements for the Contract Period to which the payment relates, but in any event not later than the 120th day (but the 180th day with respect to such Contract Period ending on December 31, 1990) after the end of such Contract Period (the “Payment Date”). As used in this Section 9.1(a), the “Funding Date” means the date on which the Company shall first borrow funds under a Post Petition Assumption and Modification Agreement between the Company and Sanwa Business Credit Corporation.

(b) For purposes of computing the Additional Consideration, “Purchaser’s Net Income” for any Contract period shall mean Purchaser’s net income after Taxes (as hereinafter defined); computed in accordance with generally accepted
accounting principles, consistently applied as to the statements of Purchaser but not as to statements of the Company, except as modified as follows:

(i) Inventory will be accounted for on a first-in, first-out basis.

(ii) Purchaser’s Net Income shall not include any amortization of negative goodwill arising from the purchase of assets which is the subject of this Agreement (the “Acquisition”).

(iii) Purchaser’s Net Income for the period commencing on the Funding Date and ending on December 31, 1990 shall be reduced by (x) all expenses incurred by Purchaser or its Affiliates with respect to the purchase of assets, including, without limitation, the fees and expenses of Purchaser’s legal and accounting advisors and (y) $250,000 (plus interest from the Closing Date to the Payment Date at the Reference Rate (as hereinafter defined) in effect as of the Closing Date). There shall be no benefit taken for such expenses in calculating the Taxes attributable to this initial Contract Period, but rather such benefits, if any, shall be realized for such purposes only if and when such costs are amortized under generally accepted accounting principles.

(iv) Purchaser’s Net Income shall be reduced by all charges, expenses, claims and monies, if any, paid by Purchaser or its Affiliates during any Contract Period, and not otherwise reimbursed, on account of or arising under or from or in any way, manner or respect related to the Consulting Agreement (as hereinafter defined) or the services to be performed by Purchaser or its Affiliates thereunder, including, but not limited to, any monies paid by Purchaser or its Affiliates in settlement or respect of any claims, demands or disputes based upon or in any way, manner or respect related to Purchaser’s or its Affiliates performance of its duties under the Consulting Agreement other than claims, demands
or disputes that are found, in a final judgment by a court of competent jurisdiction from which no appeal can be or has been taken, to have resulted principally from the Purchaser’s or its Affiliate’s bad faith, gross negligence, willful misconduct.

(v) For each Contract Period, Purchaser’s Net Income shall be reduced by a management fee payable to one or more of its Affiliates in an amount equal to one-half percent (.5%) of Purchaser’s net sales in such Contract Period, regardless of whether such fee is actually paid or is deferred. As used in this clause (e) and Section 9.6(c), “net sales” shall mean gross sales less price discounts, cash discounts, returns and allowances.

(vi) If Purchaser’s Net Income for any Contract Period is a loss, then such loss shall be carried forward to the subsequent Contract Periods and reduce such Purchaser’s Net Income during such Contract Periods until such loss is consumed.

(vii) Purchaser’s Net Income for a Contract Period shall be reduced by a deemed tax calculation (“Taxes”) as described in this clause as if Purchaser were a separate taxpaying entity. For purposes of this calculation, Taxes shall be determined based on Purchaser’s Net Income for each Contract Period using an assume date of income tax for such Contract Period equal to (a) the applicable federal rate of income tax for individuals, (b) the applicable state rate of income tax for individuals net of federal benefit, and (c) any applicable state or local rate of income tax applied to a partnership entity, such as the Illinois Replacement Tax, net of federal benefit. As used in this Section 9.1(b), the “applicable” tax rates shall be deemed to be those which are determined by Purchaser’s accountant and certified by such accountant to the Company to be the highest rates at which income of the Purchaser will be taxed to any partner of the Purchaser assuming that no partner has any other
items of taxable income, profit, deduction, loss or credit from any other source. This adjustment for Taxes (other than clause (c)) shall be provided for regardless of whether Purchaser is a partnership or other pass-through entity and shall be based on Purchaser’s Net Income and not taxable income so that Taxes include the equivalent of both current and deferred taxes. If at any time Purchaser or a successor to or assignee of Purchaser shall not be a partnership or other pass-through entity, the terms of this Section 9.1(b) shall be equitably adjusted to reflect the intent of the parties to have Purchaser’s Net Income be determined on an “after tax” basis.

(viii) During that portion of the Contract Period beginning on the Funding Date and ending on the Closing Date, Purchaser’s Net Income shall be deemed to include the Company’s Net Income or loss (determined as if the Company were “Purchaser” for purposes of clauses a–h, but utilizing the Company’s GAAP) for the period commencing on the Funding Date and ending on the Closing Date less the aggregate amount of claims accrued but unpaid as of the Funding Date, such as suppliers and lessors, to the extent such payments have not otherwise reduced net income as determined pursuant to GAAP for such period.

(c) In connection with the making of each payment by Purchaser to the Company under this Section 9.1, Purchaser shall deliver to the Company a schedule setting forth the computation of the Additional Consideration and a copy of the financial information used in making such computation. Purchaser’s computation of any payment under this Section 9.1 shall be conclusive and binding upon the parties hereto unless, within thirty business days following the Company’s receipt of the aforesaid payment and information, the Company notifies Purchaser in writing (the “Company’s Notice”) that it disagrees with Purchaser’s computation of the Additional Consideration. Such notice by the Company shall include a schedule setting forth the Company’s computation of the Additional Consideration,
together with a copy of any financial information, other than that previously supplied by Purchaser to the Company, used in making the Company’s computation.

The Company’s computation of the Additional Consideration under this Section 9.1 shall be conclusive and binding upon the parties hereto unless, within thirty business days following Purchaser’s receipt of the Company’s notice, Purchaser notifies the Company in writing that it disagrees with the Company’s computation of the Additional Consideration. If Purchaser disagrees with the Company’s computation of the Additional Consideration, Purchaser and the Company shall request a national firm of independent certified public accountants mutually agreeable to Purchaser and the Company to compute the amount of the Additional Consideration as promptly as possible, which computation shall be conclusive and binding upon Purchaser and the Company. In the event that Purchaser and the Company cannot agree on such a national firm of independent certified public accountants, then the name of the “Big 6” national accounting firms, exclusive of any such firm which is rendering or has within the past three years rendered services to Purchaser or the Company or their Affiliates, shall be selected by lottery until one such firm is willing to compute the disputed payment for purposes of this Agreement. The expenses of any computation by any such national accounting firm selected by the Purchaser and the Company to resolve computational disputes hereunder shall be borne equally by Purchaser and the Company and except for the first initial Contract Period, shall be paid in advance of performance of such services.

(d) In the event the amount of Additional Consideration to be paid by Purchaser to the Company in accordance with Section 9.1(a) for any Contract Period is recomputed in accordance with Section 9.1(c), the adjustment to amount of Additional Consideration shall be paid by Purchaser to the Company within ten business days after the date of final recomputation of such payment. If such final determination of the Additional Consideration with respect to any Contract Period shall exceed Purchaser’s original
computation of such Additional Consideration by more than ten percent (10%), then the Additional Consideration shall also include interest on such difference from the date upon which the original computation was delivered by Purchaser to the Company (the “Delivery Date”) to the date of payment of the Additional Consideration, at a annum rate equal to the “reference” rate of Continental Bank N.A. (the “Reference Rate”) as of the Delivery Date.

9.2 Retirement Option -

(a) At any time on and after the payment of the Additional Consideration in respect of the Contract Period ending December 31, 1992, but only in connection with (i) a transaction described in Section 9.6(b), or (ii) the sale of all or a substantial portion of the assets of Purchaser or of all or a substantial portion of the partnership or other equity interests in Purchaser, Purchaser shall have the option of terminating the payment of future Additional Consideration by making a lump sum payment equal in amount to the “Additional Consideration Value” (as hereinafter defined) to the Company. As used herein, “Additional Consideration Value” shall mean the amount, determined by a nationally recognized investment banking firm (the “Initial Banker”), to be mutually agreed upon by the Company and Purchaser (or if the Company and Purchaser are unable to agree, the Chicago office of Salomon Brothers Inc.), to be equal to the net present value of the Additional Consideration projected to become due with respect to periods commencing after the last Contract Period with respect of which Additional Consideration has been paid, based upon projected Purchaser’s Net Income for such Contract Periods as determined by such investment banking firm in light of such investment banking firm’s evaluation of the Purchaser’s earnings and future prospects and such other matters that such investment banking firm shall deem relevant. In determining the net present value of such Additional Consideration payments, a discount rate equal to the “reference” rate of Continental Bank, N.A. as of the close of the last Contract Period shall be utilized. The fees and expenses of the Initial Banker shall be borne by Purchaser.
(b) Upon Purchaser’s receipt of the Initial Banker’s determination of the Additional Consideration Value, it shall promptly notify the Company of such determination and the assumptions and methodology utilized in arriving at such determination and provide the written opinion of the Initial Banker as to its determination. If within thirty business days of receipt of such determination, the Company shall not object thereto, Purchaser shall be entitled to consummate the exercise of its option pursuant to Section 9.2(a). If within such thirty day period the Company shall object in writing to such determination, the Company, may appoint, at its sole cost and expense, a national recognized investment banking firm (the “Company’s Banker”) to separately undertake the evaluation prescribed by Section 9.2(a). Not later than sixty days following its written notice to Purchaser of its objection to the Initial Banker’s determination, the Company shall provide Purchaser with the Company’s Banker’s determination, including the assumptions and methodology utilizing in arriving at such determination and provide the written opinion of the Company’s Banker as to its determination. If the Company does not provide Purchaser with these materials within the sixty day period prescribed above, Purchaser shall be entitled to consummate the exercise of its option pursuant to Section 9.2(a).

(c) If within thirty days of the delivery of the determination of the Company’s Banker, the Company’s Banker and the Initial Banker are unable to resolve their differing determinations and arrive at an agreed upon value, then a third nationally recognized investment banking firm, selected by the agreement of the Initial Banker and the Company’s Banker (or if such bankers are unable to agree, a nationally recognized investment banking firm appointed by the Bankruptcy Court), shall undertake to make the determinations prescribed by Section 9.2(a). Such investment banker’s determination as to the Additional Consideration Value shall be delivered to Purchaser and the Company along with the assumptions and methodology utilized in arriving at such determination as well as the
written opinion of such investment banker as to its determination. At such time, the Additional Consideration Value shall be deemed to be the simple Average of the two closest determinations by the three investment bankers, which determination shall be final and binding upon Purchaser and the Company. The fees and expenses of such third investment banker shall be borne equally by Purchaser and the Company, and shall be paid in advance of the performance of such service.

9.3 All payments of Additional Consideration due hereunder shall be limited as follows:

(a) Until such time as (1) Purchaser shall have retired all of the indebtedness outstanding under that certain Promissory Note by Purchaser in favor of Sanwa evidencing the “COAF Loan” (as defined in the Commitment Letter) in the principal amount of $2,500,000 (the “Promissory Note”) or (ii) Sanwa shall have permanently waived the Blocking Covenant (as defined in Section 9.4 hereof), all payments of Additional Consideration shall be deferred. Upon satisfaction in full of the foregoing obligation to Sanwa, but subject to the restrictions set forth in clauses (b) and (c) below, such deferred payments of Additional Consideration shall be promptly paid to the Company.

(b) If at any time when a payment of Additional Consideration is to be paid, there shall then exist a default on the payment of principal or interest due from Purchaser to any institutional or commercial lender (“Lender”) not Affiliated with Purchaser, or there shall exist any other default under any agreement governing secured indebtedness owed by the Purchaser to any Lender, then the payment of such Additional Consideration shall be deferred, and shall be paid promptly to the Company upon the cure or waiver of such default, subject to the terms of clauses (a) and (c) of this Section.

(c) If, on the tenth business day prior to a Payment Date or, with respect to deferred payments of Additional Consideration, the tenth business day prior to the date upon which such a deferred payment is to be paid (each, a
“Measurement Date”), the amount (such amount is hereinafter “Available Funds”) equal to (i) all amounts available for borrowing under Purchaser’s revolving lines of credit on the Measurement Date plus (ii) the Company’s cash on hand as of the Measurement Date less (iii) an amount equal to 10% of Purchaser’s then outstanding borrowings under its revolving lines of credit on the Measurement Date less (iv) to the extent not previously applied pursuant to this calculation, all amounts paid by Purchaser in satisfaction of the Promissory Note shall be less than the amount of Additional Consideration then due and payable (including amounts due respect to any prior Contract Periods), then the payments of Additional Consideration due on such date shall be limited to the Amount of Available Funds. If any such deferral of payments shall occur pursuant to this Clause (c), then at the close of each fiscal quarter of the Company following such deferral, the Company shall recalculate its Available Funds as of the last business day of such quarter (which shall be deemed the Measurement Date for such purposes) and shall make payments of such deferred Additional Consideration equal to the amount of such Available Funds within 45 days of the close of such quarter, subject to the restrictions set forth in clauses (a) and (b), above.

(d) If any payment of Additional Consideration is deferred pursuant to this Section 9.3 (each a “Deferred Payment”), then (i) such Deferred Payment shall accrue interest from the Payment Date to the date upon which such Deferred Payment (or portion thereof) is finally paid, at the Reference Rate, as adjusted on each anniversary of the subject Payment Date (but such interest shall not compound), and (ii) notwithstanding anything to the contrary contained in this Section 9.3, no Deferred Payment shall be deferred past the fifth anniversary of the Payment Date upon which it was originally due.
APPENDIX B

SECTION 2.1 Definition of EBIT.

“EBIT” means the consolidated net income of the Company and its subsidiaries before interest and federal and state income taxes determined in accordance with GAAP (as defined in Exhibit E hereto), applied consistent with past practices of the Company, for the fiscal years ending August 31, 1994, 1995 and 1996, as the case may be, modified as follows:

A. to the extent included in the consolidated net income of the Company, excluding the effect of the following items:

1. the gain or loss from any sale, exchange or other disposition of assets other than in the ordinary course of business consistent with past practice, except for (x) sales of inventory covered by Section 2.1.D. hereof or (y) sales of product lines, brands or Proprietary Rights covered by Section 2.1.B. hereof;

2. the gain or loss from the exchange of securities, or any increase or reduction in the carrying value of such securities, or any increase or reduction in the carrying value of such securities;

3. any extraordinary gain or loss;

4. any additional depreciation, amortization or other expense resulting from the write-up of any asset and any amortization of goodwill or other intangibles relating to the acquisition of the Company by Acquiror;

5. any expenses directly or indirectly incurred in connection with the financing of the acquisition of the Company or any refinancing of such indebtedness or any other financing not reflected in the 1993 Financial Statements; 6. the effect of valuing inventories on a last-in-first-out basis;

6. the effect of valuing inventories on a last-in-first-out basis;
7. any gain, loss, income or expense resulting from a change in the Company’s accounting methods, principles or practices or a change in GAAP or any GAAP election or treatment not made or utilized by the Company in its audited financial statements for its fiscal year 1993;

8. intercompany charges between the Company or any Company Subsidiary and the Acquiror which have not been approved by Goodman or the Seller Representatives;

9. any costs or expenses (including payments under the Phantom Stock Plan) (as defined in Section 3.4) caused by or arising out of the Phantom Stock Plan;

10. any employee termination or other costs arising out of a consolidation of services or facilities or other rationalization of the Company or the Company Subsidiaries subsequent to the acquisition by the Acquiror of the Company;

11. any gain resulting from the contemplated sale of certain assets located in the Company’s Carson, California facility;

12. any employment related costs associated with personnel required by Acquiror to be employed by the Company that the Company would not otherwise have employed;

13. any expenses directly or indirectly incurred in connection with the acquisition of the Company by Acquiror; and

14. any reserves or adjustments to reserves which are not consistent with past practices of the Company.

B. the pre-tax profits resulting from or derived out of (i) the sale of any product line, brand or Proprietary Right disposed of by the Company with the prior written consent of Acquiror after the date of this Agreement or (ii) the expiration by its terms or termination by the supplier of any supply agreement between the Company or any Company Subsidiary and a supplier, shall be included in EBIT and amortized equally over the remaining months in the period commencing on the earliest of (x) the expiration date of the agreement, (y) the date of the agreement to dispose of such product
lines or brands was publicly announced, and (z) the date of such agreement, as the case may be, and in each case ending on August 31, 1996;

C. in the event the Company fails in any given fiscal year to meet the “EBIT Target” for such year (respectively $24,985,000 for the year ended August 31, 1994, $26,497,000 for the year ended August 31, 1995, and $28,551,000 for the year ended August 31, 1996), EBIT for such fiscal year shall be increased by an amount reasonably determined by Acquiror and the Seller Representatives to reflect contributions to the earnings before interest and taxes of Acquiror resulting from sales, distribution or purchases which the Company or any of the Company Subsidiaries introduced to Acquiror (or its subsidiaries or affiliates) including, without limitation, sales or distribution of wine, brandies or grape concentrate, and sales of liquor and/or beer by Acquiror (or its subsidiaries or affiliates) produced by the Company or any of the Company Subsidiaries;

D. any gains or losses from the trading of inventory in bulk shall be included in the computation of EBIT so long as the Company and the Company Subsidiaries maintain inventory at levels reasonable in relation to the circumstances of their respective businesses; and

E. any other adjustments agreed to by Acquiror and the Seller Representatives.

SECTION 2.2 First Payment. As additional consideration for the sale of the Shares, subject to the provisions of Section 2.8, on December 31, 1993, Acquiror shall pay to the Sellers an aggregate amount, subject to reduction as provided in Section 9.6, of $3,768,181 plus interest at a rate of 1% per month, compounded monthly, on such amount from June 30, 1993 through December 31, 1993.

SECTION 2.3 Second Payment. As additional consideration for the sale of the Shares, subject to the provisions of Section 2.8, upon EBIT for the fiscal year ended August 31, 1994 ("1994 EBIT") exceeding $17,800,000 ("1994 Base"), Acquiror shall pay to the Sellers, on December 30, 1994, an aggregate amount, subject to reduction as provided in Section 9.6, equal to:

A. $8,443,775 plus interest at a rate of 1% per month, compounded monthly, on such amount from June 30, 1993 through December 31, 1994 (the "1994 Maximum Payment"), multiplied by
B. a fraction, the numerator of which is the lesser of (i) the dollar amount by which 1994 EBIT exceeds the 1994 Base or (ii) $7,185,000 (the “1994 Numerator”) and, the denominator of which is $7,185,000 (such amount being referred to as the “Second Payment”).

SECTION 2.4 Third Payment. As additional consideration for the sale of the Shares, subject to the provisions of Section 2.8, on December 30, 1994, Acquiror shall pay to the Sellers an aggregate amount, subject to reduction as provided in Section 9.6, of $15,215,515 plus interest at a rate of 1% per month, compounded monthly, on such amount from June 30, 1993 through December 31, 1994.

SECTION 2.5 Fourth Payment. As additional consideration for the sale of the Shares, subject to the provisions of Section 2.8, upon EBIT for the fiscal year ended August 31, 1995 (“1995 EBIT”) exceeding $19,500,000 (“1995 Base”), Acquiror shall pay to the Sellers, on November 30, 1995, an aggregate amount, subject to reduction as provided in Section 9.6, equal to:

A. (i) $7,493,422 plus interest at a rate of 1% per month, compounded monthly, on such amount from June 30, 1993 through November 30, 1995 (the “1995 Maximum Payment”), multiplied by (ii) a fraction, the numerator of which is the lesser of (A) the dollar amount by which 1995 EBIT exceeds the 1995 Base or (B) $6,997,000 (the “1995 Numerator”), and the denominator of which is $6,997,000, plus

B. an amount equal to (i) the 1994 Maximum Payment multiplied by a fraction, the numerator of which is the lesser of (A) the 1994 Numerator plus the amount by which 1995 EBIT exceeds $26,497,000 or (B) $7,185,000, and the denominator of which is $7,185,000, less (ii) the amount of the Second Payment (such aggregate amount being referred to as the “Fourth Payment”).

SECTION 2.6 Fifth Payment. As additional consideration for the sale of the Shares, subject to the provisions of Section 2.8, upon EBIT for the fiscal year ended August 31, 1996 (“1996 EBIT”) exceeding $21,200,000 (“1996 Base”), Acquiror shall pay to the Sellers, on November 29, 1996, an aggregate amount, subject to reduction as provided in Section 9.6, equal to:

A. (i) $9,975,047 plus interest at a rate of 1% per month, compounded monthly, on such amount from June 30, 1993 through November 30, 1996, multiplied by (ii) a fraction, the numerator of which is
the lesser of (A) the dollar amount by which 1996 EBIT exceeds the 1996 Base or (B) $7,351,000, and the denominator of which is $7,351,000, plus

B. an amount equal to (i) the 1995 Maximum Payment multiplied by a fraction, the numerator of which is the lesser of (A) the 1995 Numerator plus the amount by which 1996 EBIT exceeds $28,551,000 or (B) $6,997,000, and the denominator of which is $6,997,000, less (ii) the amount of the Fourth Payment (exclusive of amounts included therein pursuant to clause B. of Section 2.5).

SECTION 2.7 Delivery of EBIT Financial Statements. Within forty-five (45) days after the end of each of the Company’s fiscal years ending August 31, 1994, 1995 and 1996, the Seller Representatives shall have prepared and delivered to Acquiror the consolidated balance sheet and income statements for such year for the Company and the Company Subsidiaries (the “EBIT Financial Statements”) which statements shall have been prepared in accordance with GAAP (excluding footnotes and other disclosures required by GAAP), applied consistent with past practices, along with a statement setting forth in reasonable detail the computation of EBIT, including identification of all excluded items and adjustments and all necessary back up calculations. The Company and Acquiror shall promptly provide to the Seller Representatives all information which the Seller Representatives shall reasonably request in connection with preparation of the EBIT Financial Statements. The Seller Representatives’ calculation of EBIT shall be used in determining the amounts to be paid under this Article II unless Acquiror has given the Seller Representatives notice (the “EBIT Dispute Notice”) that Acquiror disputes the Seller Representatives’ calculation of EBIT within thirty (30) days after the initial determination of EBIT has been given to Acquiror, which notice shall set forth in reasonable detail the exclusions or calculations being disputed in good faith. In the event an EBIT Dispute Notice is timely given to the Seller Representatives, Acquiror and the Seller Representatives shall have fifteen (15) days to resolve the dispute and if not resolved, the dispute shall be submitted to a nationally recognized “Big Six” accounting firm or its successor (other than auditors used by Acquiror or the Company within the past three (3) years, or their successors) chosen by lot (the “EBIT Arbitrator”) which shall be instructed to arbitrate such disputed item(s) and determine EBIT within thirty (30) days. The resolution of disputes by the EBIT Arbitrator shall be set forth in writing and shall be conclusive and binding upon and non-appealable by the parties, and the determination of EBIT shall become final upon the date of such resolution, and may be entered as a final judgment in any court of proper jurisdiction.
SECTION 2.8. Payment of Amounts Not in Dispute. Notwithstanding anything in this Agreement to the contrary, if a Dispute Notice or an EBIT Dispute Notice has been delivered with respect to any payment to be made under Sections 2.2, 2.3, 2.4, 2.5 or 2.6 of this Article II, and the dispute has not been resolved by the payment due date, (a) the amount not in dispute shall be paid as required hereunder; and (b) Acquiror shall have no obligation to pay any amount in dispute until ten (10) days after the date on which the dispute is resolved.

SECTION 2.9. Payment of Interest on Disputed Amounts. Interest at the rate of two percent (2%) over Acquiror’s cost of borrowed funds under its revolving credit facility shall be paid by Acquiror on all amounts required by the EBIT Arbitrator or the Arbitrators to be paid to the Sellers from the later of (a) the required payment date or (b) 31 days after the EBIT Financial Statements have been given to Acquiror, until the date of payment.

SECTION 2.10. Postponement of Payment Date. Notwithstanding the other provisions of this Article II, in the event the EBIT Financial Statements are not given to Acquiror within the required 45 day period after the end of the Company’s fiscal year, Acquiror shall have no obligation to make any payment under Sections 2.3, 2.5 and 2.6 until the later of the required payment date or the date 31 days after the EBIT Financial Statements have been given to Acquiror, which payment shall not be adjusted for any interest from the required payment date.

SECTION 2.11. Manner of Payment. All payments required to be made to the Sellers under this Article II shall be made in cash to each of them in accordance with their respective percentage interests in the Company as set forth opposite the name of such Seller on Exhibit A by delivery of certified checks to such Seller at the address set forth under the name of such Seller on Exhibit A hereto or as otherwise directed by the Seller Representatives.

SECTION 2.12. Letter of Credit.

A. In order to secure the obligations of Acquiror under this Article II, the Acquiror shall deliver to the Seller Representatives, on behalf of the Sellers, at the Closing a standby irrevocable letter of credit in favor of the Sellers in an initial face amount of $28,200,000, which letter of credit shall be in the form attached hereto as Exhibit F (the “Letter of Credit”). Effective January 31, 1995, the face amount of the Letter of Credit shall be reduced to an amount equal to the sum of $25,000,000 plus any amounts up to $3,200,000 which are then in dispute; provided that, as soon as practicable
after such disputes have been resolved and the required payments have been made, the face amount of the Letter of Credit shall be reduced to $25,000,000. Effective December 31, 1995, the face amount of the Letter of Credit shall be reduced to an amount equal to the sum of $15,000,000 plus any amounts up to $10,000,000 which are then in dispute; provided that, as soon as practicable after such disputes have been resolved and the required payments have been made, the face amount of the Letter of Credit shall be reduced to $15,000,000. The parties hereto agree to take all action necessary to cause the Letter of Credit to be reduced as provided in this Section 2.12.A. In the event that, on the expiration date of the Letter of Credit, a portion of the payment to be made under this Article II is in dispute, Acquiror shall renew the Letter of Credit in a face amount equal to the amount in dispute (the “Renewed Letter of Credit”) and shall cause the expiration date of the Renewed Letter of Credit to be extended as required from time to time to a date which is ten (10) days after the date on which the dispute is resolved (whether by agreement between Acquiror and the Seller Representatives, on behalf of the Sellers, or by a decision of the Arbitrators or the EBIT Arbitrator, as the case may be).

B. The letter of credit fee (no greater than 1 5/8% annually, which may be reduced to 1 1/2% annually), the letter of credit fronting fee (no greater than 1/8% annually) and the proportionate share of the syndication fee (a one-time fee no greater than 1 3/8%) associated with the Letter of Credit (the “LC Fees”), and all other fees and costs associated with the Letter of Credit and the Renewed Letter of Credit shall be paid by Acquiror. In the event that Acquiror renegotiates the fees charged or to be charged under the Commitment Letter (as defined below) or any amendment thereto or replacement thereof, any reduction in financing costs resulting from such renegotiation shall be applied ratably and equitably between the LC Fees and the other fees and financing costs. On or before January 15, 1997, Acquiror hereby agrees to pay to the Seller Representatives, on behalf of the Sellers, an amount equal to (i) $883,000 plus interest at an annual rate of 4% on the remaining balance from Closing until the date of payment (the “Adjusted LC Payment”) less (ii) one-half (‘h) of the LC Fees paid by Acquiror with respect to the Letter of Credit (the “Sellers’ LC Portion”). In the event that the Sellers’ LC Portion is greater than the Adjusted LC Payment, Acquiror shall have the right to recoup such excess by reducing any amounts Acquiror is otherwise
required to pay to the Sellers under this Agreement, without regard to any limitations otherwise provided in this Agreement.

SECTION 2.13. Acceleration.

A. Each of the following shall constitute an Event of Default with respect to this Article II:

1. failure by Acquiror to pay any amount when due under this Article II or to deposit the Escrow Security or make the Additional Security Payment as and when required by Section 1.3.D.;

2. default in the payment when due (subject to any applicable grace period) of any obligation of Acquiror or any Acquiror Subsidiary for borrowed money or in respect of obligations, loans or advances, individually or in the aggregate, in an amount or amounts in excess of $20,000,000 if the effect of such default is to accelerate the maturity of such obligation, loan or advance;

3. Acquiror or any Significant Subsidiary (as defined) of Acquiror applies for, consents to, or acquiesces in the appointment of a trustee, receiver or other custodian for Acquiror or any Significant Subsidiary of Acquiror or a substantial part of the property of Acquiror or any Significant Subsidiary of Acquiror, or makes a general assignment for the benefit of creditors; or in the absence of such application, consent or acquiescence, a trustee, receiver or other custodian is appointed for Acquiror or any Significant Subsidiary of Acquiror, or for a substantial part of the property of Acquiror or any Significant Subsidiary of Acquiror and is not discharged or dismissed within 30 days;

4. any bankruptcy, reorganization, debt arrangement or other proceeding under any bankruptcy or insolvency law, or any dissolution or liquidation proceeding, is instituted by or against Acquiror or any Significant Subsidiary of Acquiror, and if instituted against Acquiror or any such Significant Subsidiary, is not dismissed within 30 days;
5. termination by acquiror of the Goodman Employment Agreement other than for Cause, as defined in such agreement;

6. a Change of Control (as defined in Exhibit E);

7. failure to renew or keep renewed the Letter of Credit as required by Section 2.12.A.; or

8. Chase gives notice pursuant to the Letter of Credit that the Letter of Credit will be terminated.

B. 1. In the event that one or more Events of Default described in Section 2.13.A.3. or 4. shall occur, then the maximum then-remaining payments (including interest to the scheduled payment date) possible under this Article II (deeming for such purposes that all of the contingencies to such payments have been satisfied) (“Liabilities”), shall be immediately due and payable without demand, notice or declaration of any kind whatsoever; (ii) in the event that one or more of the Events of Default described in Section 2.13.A.1., 2., 5. or 6. shall occur, then upon notice having been given to Acquiror of such Event of Default, the Seller Representatives may declare all Liabilities immediately due and payable; provided that with respect to an Event of Default under Section 2.13.A.6. the amount of the Liabilities shall be equal to the present value of such Liabilities, utilizing a discount rate of the prime rate of Chase Manhattan Bank, N.A. in effect on such date; (iii) in the event that the Event of Default described in Section 2.13.A.7. shall occur, the Sellers may draw the entire amount of the Letter of Credit and shall immediately pay such amount to the Seller Representatives until any disputes under this Agreement resolved (whether by agreement of Acquiror and the Seller Representatives or by the Arbitrators or EBIT Arbitrator, as the case may be), at which time the Seller Representatives shall pay to Acquiror the amounts due to Acquiror plus interest, if any, under this Agreement, and the balance shall be paid to the Sellers in accordance with their respective interests set forth on Exhibit A; (iv) in the event of an Event of Default ‘as described in Section 2.13.A.8., Liabilities equal in amount
to, but no greater than, the then face amount of the Letter of Credit shall be immediately due and payable without demand, notice or declaration of any kind whatsoever. In the event of the occurrence of any Event of Default, the Seller Representatives, on behalf of the Sellers, may exercise any one or more or all of the following remedies, all of which are cumulative and non-exclusive: (A) any remedy contained in this Agreement, (B) any rights and remedies available to the Sellers under any applicable law, and (C) may draw the entire amount of the Letter of Credit; provided that drawing under the Letter of Credit shall be the exclusive remedy upon an Event of Default described in Section 2.13.A.8.
APPENDIX C

1. UNITED HEALTHCARE CORPORATION
   Source: Form 8-K filed October 2, 1995

SECTION 2.05 Contingent Payment Rights.

(a) Each Contingent Payment Right shall represent only a right to receive a cash payment (the “Earn-Out”) from Acquiror, subject to the terms set forth in this Section 2.05. The amount of any Earn-Out payment payable with respect to each Contingent Payment Right shall be equal to the aggregate Earn-Out payment payable, calculated as set forth below, divided by the total number of Contingent Payment Rights outstanding as of the date such payment is due. Not later than 10 days following the completion of the audit of Acquiror’s financial statements for each Earn-Out Year (as defined below), Acquiror shall prepare and deliver to the Stockholders entitled to receive payment a statement (the “Earn-Out Statement”) setting forth the amount of Earnings Per Share (as defined below), the amount of the Earn-Out, if any, payable for such Earn-Out Year in accordance with this Section 2.05 and a reasonably detailed description of the calculations of such Earnings Per Share and Earn-Out amount. The amount of the Earn-Out payment reflected on the Earn-Out Statement shall be paid by Acquiror to the holders of Contingent Payment Rights not later than the tenth business day following the date the Earn-Out Statement is required to be delivered to the Stockholders entitled to receive payment (the “Earn-Out Payment Date”). Any objections made to the calculation of Earnings Per Share and/or the amount of the Earn-Out payment shall be resolved in accordance with Section 2.05(f). In connection with any payment of the Earn-Out, Acquiror shall also pay to each holder of Contingent Payment Rights interest on the amount of the Earn-Out determined to be payable under this Section 2.05 to such holder for the period beginning on the Earn-Out Payment Date to the date such amount is actually paid, at the rate specified in Section 10.06. Contingent Payment Rights shall not possess any attributes of common stock or other security and shall not entitle the holders of the Contingent Payment Rights to any rights of any kind other than as specifically set forth in this Agreement.

(b) The term “Earn-Out Year” shall refer to each of the following twelve-month periods: (i) the period from January 1, 1996 through December 31, 1996; and (ii) the period from January 1, 1997 through December 31, 1997.
(c) The Earn-Out payments shall be determined by measuring Acquiror’s Earnings Per Share for Earn-Out Years 1996 and 1997 against Threshold Earnings Per Share and Maximum Earnings Per Share for such Earn-Out Years, calculated as set forth on Exhibit 2.05.

(d) Failure to achieve the Threshold Earnings Per Share amount in any Earn-Out Year will result in no Earn-Out payment being made for that Earn-Out Year. Achieving the Maximum or greater Earnings Per Share in any Earn-Out Year will result in the maximum Earn-Out payment to all holders of Contingent Payment Rights, collectively, of $175,000,000 being made for that Earn-Out Year. Earnings Per Share in any Earn-Out Year which is between the Threshold and Maximum Earnings Per Share amounts for such year will result in an Earn-Out payment to all holders of Contingent Payment Rights, collectively, being made for that Earn-Out Year calculated as follows:

\[ \text{Aggregate Earn-Out payment} = \frac{(X - Y)}{(Z - Y)} \times 175,000,000 \]

Where:
- \( X \) = the actual Earnings Per Share for an Earn-Out Year,
- \( Y \) = the Threshold Earnings Per Share for an Earn-Out Year
- \( Z \) = the Maximum Earnings Per Share for an Earn-Out Year

Note: \( X \) will be calculated to four decimal places and rounded to the nearest two decimal places.

(e) “Earnings Per Share” for each Earn-Out Year shall be determined in accordance with the provisions of Exhibit 2.05.

(f) If a Stockholder entitled to receive payment shall have any objections to the Earn-Out Statement, such Stockholder shall deliver a reasonably detailed statement describing its objections to Acquiror within 30 days after receiving the Earn-Out Statement in question. In the event such statement is not delivered to Acquiror within such 30-day period, Acquiror’s calculation of Earnings Per Share and the Earn-Out payment, as set forth in the Earn-Out Statement, shall be conclusive as to such Stockholder. The Stockholders entitled to receive payment and Acquiror will use reasonable efforts to resolve any objections to the calculation of Earnings Per Share and/or the Earn-Out Payment which are timely raised by such Stockholders. If the parties do not obtain a final resolution within 20 days after Acquiror’s receipt of a statement of objections, the Stockholders entitled to receive payment and Acquiror will select an accounting firm mutually acceptable to them to resolve any remaining objections. If such Stockholders and Acquiror are unable to agree on the choice of an accounting firm, such accounting firm will be selected by lot from a list of nationally recognized accounting firms,
after excluding the regular outside accounting firms of Acquiror and each such Stockholder. The determination of any accounting firm so selected will be set forth in writing and will be conclusive and binding upon the parties. If such accounting firm determines that the Stockholders are entitled, under this Section 2.05, to an additional payment from Acquiror, the Acquiror shall pay such amount with interest from the Earn-Out Payment Date to the date such amount is actually paid at the rate specified in Section 10.06. In the event that the parties submit any unresolved objections to an accounting firm for resolution as provided in this Section 2.05(f), the fees and expenses of the accounting firm shall (i) be borne by the objecting Stockholder if such accounting firm determines that no additional payment is due to such Stockholder, (ii) be borne equally by Acquiror and such Stockholder if the payment which such accounting firm determines to be due to such Stockholder does not exceed the Earn-Out payment reflected on the Earn-Out Statement by more than $5,000,000, or (iii) be borne by Acquiror if the payment which such accounting firm determines to be due to such Stockholder exceeds the Earn-Out payment reflected on the Earn-Out Statement by more than $5,000,000.

(g) The Contingent Payment Rights are personal to each initial holder thereof and shall not be transferable for any reason other than (i) to an affiliate of such holder, (ii) to another holder of Contingent Payment Rights or (iii) by operation of law or by will or the laws of descent and distribution. Any attempted transfer of a Contingent Payment Right by any holder thereof (other than as permitted by the immediately preceding sentence) shall be null and void.

(h) Payment of the Earn-Out shall be made by cashier’s or certified check or, if requested by a person entitled to receive payment, by wire transfer of immediately available funds to an account specified by such person, after taking such action as is necessary to assure that all applicable federal or state income withholding and any other taxes are withheld and deducted from such funds otherwise to be paid to the holders of Contingent Payment Rights. Each payment of the Earn-Out shall, to the extent required by Law, be deemed to include interest at the applicable federal rate under the Code (it being understood that such deemed interest will not affect the amount due and payable, if any, under this Section 2.05).

(i) In the event that an Acquiror Change of Control occurs prior to the end of the second Earn-Out Year, Acquiror will, prior to or at the time of such Acquiror Change of Control, make appropriate provision or cause appropriate provision to be made (in each case reasonably satisfactory to the Stockholders entitled to receive payment) so that (i) the Earn-Out can be calculated and paid (if the targets for payment are met) following such Acquiror Change of Control, and
(ii) Acquiror’s obligations under this Section 2.05 are expressly assumed by the acquiring person. This Section 2.05, and Acquiror’s obligation to pay the Earn-Out hereunder, shall survive any Acquiror Change of Control which is effected in such a manner that Acquiror does not have the opportunity to comply with the provisions of the first sentence of this Section 2.05(i). In the event that (x) Acquiror does not comply with the provisions of the first sentence of this Section 2.05(i) in connection with an Acquiror Change of Control, or (y) following any Acquiror Change of Control and prior to the end of the second Earn-Out Year, the acquiring person (1) disposes of any material portion of the businesses conducted by Acquiror as of the Acquiror Change of Control so as to adversely affect Earnings Per Share or (2) engages in any other transaction or reorganization that makes calculation of Earnings Per Share impossible or unduly burdensome (in each case, an “Earn-Out Default”), then the maximum amount of the Earn-Out payment for (A) the year in which the Earn-Out Default occurs and (B) for the second Earn-Out Year (if the Earn-Out Default occurs in the first Earn-Out Year), shall become due and payable upon consummation of the Acquiror Change of Control in the case of clause (x) above or immediately upon occurrence of the circumstances described in clause (y) above.

[Exhibit 2.05 to the United Healthcare Merger Agreement was not available from the SEC at the time of publication.]
2. ROUSE COMPANY
Source: Registration Statement filed May 14, 1996

THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS

The following is a summary of the material terms of the Contingent Stock Agreement and the Contractual Rights. This summary does not purport to be a complete description of the Contingent Stock Agreement and the Contractual Rights and is qualified in its entirety by reference to the Contingent Stock Agreement, a copy of which is attached as Appendix D to this Proxy Statement/Prospectus and is incorporated herein by reference.

GENERAL

Pursuant to the terms of the Contingent Stock Agreement to be entered into by Rouse on the Closing Date, but to be deemed effective as of January 1, 1996, for the benefit of the Holders and the Representatives, the Holders will receive as part of the consideration in the THC Merger, pro rata based on the number of shares of THC Common Stock held by them immediately prior to the Effective Time, the Contractual Rights, which entitle the Holders to certain future distributions of Contingent Shares or, if Rouse is unable to deliver Contingent Shares for any reason or upon certain other events at the election of the Representatives, Contingent Preferred Shares. The number of Contingent Shares to be issued in respect of the Contractual Rights will be determined on the basis of (i) the Excess Cash Flow (as defined below) of each of four Business Units over Earnout Periods ranging from five to 14 years after the Effective Time, depending on the Business Unit and (ii) the appraised value of the assets of each such Business Unit at the end of the applicable Earnout Period.

The Contractual Rights (i) will not be represented by any form of certificate or instrument; (ii) do not give the Stockholders dividend rights, voting rights, liquidation rights, preemptive rights or other rights common to holders of Rouse Common Stock or Rouse Preferred Stock; (iii) are not redeemable; (iv) may not be transferred or assigned by any Holder, except (a) to a beneficial owner of equity interests of a Holder as of the date of the Contingent Stock Agreement, (b) pursuant to the laws of descent and distribution, (c) to an inter vivos trust for the benefit of a Holder or a beneficial owner or a member of such person’s immediate family, (d) by operation of law or (e) to Rouse or its subsidiaries and (v) do not entitle the Holders to participate in the growth or earnings of Rouse, except to the extent of the rights of such Holders to be paid Rouse Common Stock or Increasing Rate Preferred Stock the amounts of which will be determined by
the Excess Cash Flow and the appraised value of the assets of any Business Unit at the end of the applicable Earnout Period. The terms of the Contractual Rights may be amended by written agreement between Rouse and the Representatives, except that amendments of certain provisions require the consent of the Holders of a majority in interest of the Contractual Rights or of all of the Holders. Under certain circumstances, the Holders are entitled to have an individual designated for election to the Board of Directors of Rouse on their behalf. See “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Amendments and Waiver” and “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Board Representation.” For a discussion of the provisions of the Rouse By-Laws relating to certain business combinations see “DESCRIPTION OF ROUSE COMMON STOCK--Special Statutory Requirements for Certain Transactions--Business Combination Statute.”

FOR A DISCUSSION OF CERTAIN RISKS RELATING TO THE CONTINGENT STOCK AGREEMENT, SEE “RISK FACTORS--RISKS RELATING TO THE CONTINGENT STOCK AGREEMENT, THE CONTINGENT SHARES AND THE CONTINGENT PREFERRED SHARES” AND “RISK FACTORS--ADDITIONAL RISKS RELATING TO THE BUSINESS OF THC AND ITS SUBSIDIARIES.”

THE BUSINESS UNITS

The assets comprising the Business Units consist of all rights, title and interests (subject to any related liabilities) of THC and its subsidiaries in and to:

(a)(i) certain undeveloped land located in Nevada and California currently owned by THC and HHPLP, directly or indirectly (comprised of all of the investment acreage, with the exception of Summerlin investment acreage, described under “THE HUGHES CORPORATION--Overview”), all undeveloped land at Airport Center, Hughes Center and Cheyenne Center in Las Vegas, Nevada and (ii) any equity interests of THC and its subsidiaries in any person holding any of the foregoing assets, and any securities or other property distributed in exchange for or with respect to such equity interests (collectively, the “General Business Unit”);

(b)(i) HHC, an approximately 69-acre tract of land (and all improvements thereon) in Los Angeles, California and (ii) any equity interests of THC and its subsidiaries in any person holding any of the foregoing assets, and any securities or other property distributed in exchange for or with respect to such equity interests (collectively, the “Howard Hughes Center Business Unit”);
(c) the limited partnership interests held by HHPLP in the PV Partnerships and any securities or other property distributed in exchange for or with respect to such partnership interests (collectively, the “Playa Vista Business Unit”); and

(d)(i) all undeveloped land owned by HHPLP in Summerlin South, Summerlin West and Summerlin North, all of which are part of Summerlin, a master-planned community in Las Vegas, Nevada, (ii) the TPC, and (iii) any equity interests of THC and its subsidiaries in any person holding any of the foregoing assets, and any securities or other property distributed in exchange for or with respect to such equity interests (collectively, the “Summerlin Business Unit”).

The assets of the Business Units represent undeveloped land (or interests therein) and certain rental properties (or interests therein) held at January 1, 1996 by THC and its subsidiaries. The rental properties included in the Business Units contributed approximately $17,495,000 of the operating revenues of THC and its subsidiaries for the year ended December 31, 1995, or 27% of the operating revenues of THC and its subsidiaries attributable to rental properties. Approximately $122,080,000 (or approximately 42%), approximately $105,960,000 (or approximately 36%) and approximately $65,344,000 (or approximately 22%) of the operating revenues of THC and its subsidiaries for the year ended December 31, 1995 were attributable to revenues from sales of development properties, revenues from sales of investment properties and revenues from rental properties, respectively. For the years ended December 31, 1994 and December 31, 1993, respectively, approximately $98,050,000 (or 58%) and $63,030,000 (or 47%) of operating revenues of THC and its subsidiaries were attributable to revenues from sales of development properties, approximately $11,950,000 (or 7%) and $19,353,000 (or 14%) of operating revenues of THC and its subsidiaries were attributable to revenues from sales of investment properties, and approximately $59,926,000 (or 35%) and $53,014,000 (or 39%) of operating revenues of THC and its subsidiaries were attributable to revenues from rental properties. Accordingly, it is expected that the majority of the future operating revenues (and cash flows) of the Business Units will be derived from sales of development properties and investment properties included in the assets comprising the Business Units. There can be no assurance as to future operating revenues or cash flows of the Business Units from sales of development properties and investment properties or as to future revenues of the Business Units from rental properties, and future revenues or cash flows may be materially greater or less than such historical revenues or cash flows.
The approximate book value of the assets of each Business Unit as of December 31, 1995, and the approximate amount of the operating revenues of THC and its subsidiaries for the year ended December 31, 1995 attributable to rental properties included in each Business Unit, are estimated to be as set forth in the following table:

<table>
<thead>
<tr>
<th>BUSINESS UNIT</th>
<th>BOOK VALUE OF ASSETS AS OF DECEMBER 31, 1995</th>
<th>OPERATING REVENUES FROM RENTAL PROPERTIES YEAR ENDED DECEMBER 31, 1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Business Unit</td>
<td>$33,577,000</td>
<td>-----</td>
</tr>
<tr>
<td>Howard Hughes Center Business Unit</td>
<td>73,660,000</td>
<td>$10,787,000</td>
</tr>
<tr>
<td>Playa Vista Business Unit</td>
<td>-----</td>
<td>-----</td>
</tr>
<tr>
<td>Summerlin Business Unit</td>
<td>$120,367,000</td>
<td>6,708,000</td>
</tr>
<tr>
<td>Total</td>
<td>$227,604,000</td>
<td>$17,495,000</td>
</tr>
</tbody>
</table>

For additional information regarding the assets included in the Business Units see “THE HUGHES CORPORATION,” “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF THC” and the Consolidated Financial Statements of THC and Notes thereto included elsewhere in this Proxy Statement/Prospectus.

DISTRIBUTIONS OF CONTINGENT SHARES BASED UPON CASH FLOW CERTAIN DEFINITIONS. In this Proxy Statement/Prospectus, the following terms have the meanings set forth below:

“Calculation Date” means the last day of each Computation Period.

“Computation Period” means, for each Business Unit, the six-month period beginning on January 1 and July 1 of each year, commencing January 1, 1996 and ending on the Valuation Date for the applicable Business Unit.

“Computation Period Tax Adjustment” means, with respect to any Business Unit for any Computation Period, the sum of (i) the product of (A) the pro forma taxable income or loss for such Business Unit, utilizing the method of tax accounting and, to the extent applicable, the elections used in preparing Rouse’s consolidated federal income tax return, but treating each Business Unit as
though it were a separate corporation filing a separate tax return times (B) 33.33% of the marginal tax rate applicable to corporations subject to Subchapter C of Chapter 1 of Subtitle A of the Code for each item of taxable income or loss for such Business Unit for the period in which such income or loss was realized or sustained plus (ii) 33.33% of the aggregate income taxes that would be imposed on the income of such Business Unit by each state or local tax authority (“jurisdiction”) as a result of the location of assets or the operations of such Business Unit within such jurisdiction, computed as if the assets and operations of such Business Unit in such jurisdiction were owned and conducted by a separate corporation with no contacts or nexus with any other jurisdiction, as estimated by the Rouse (and subject to adjustment based on calendar year results), provided that the Computation Period Tax Adjustment shall not be a negative number. If any calculation of the Computation Period Tax Adjustment results in a loss, such loss will be carried forward to future periods.

“Excess Cash Flow” means, with respect to any Business Unit for any Computation Period, an amount equal to (i) all cash, cash equivalents and marketable securities actually received by Rouse and its subsidiaries with respect to such Business Unit during such Computation Period and all adjustments to the records and accounts of such Business Unit which have the effect of increasing the cash accounts of such Business Unit for such Computation Period less (ii) all costs and expenses actually incurred by Rouse and its subsidiaries during such Computation Period which are properly chargeable to such Business Unit and all adjustments to the records and accounts of such Business Unit which have the effect of decreasing the cash accounts of such Business Unit for such Computation Period and less (iii) the Computation Period Tax Adjustment.

“General Business Unit Reduction Amount” means, with respect to any Calculation Date, an amount equal to the sum of (i) 3% of the gross cash proceeds from sales of real estate included in the General Business Unit during all Computation Periods, reduced by all amounts taken into account in all prior Computation Periods plus (ii) to the extent that all or any portion of the amount under clause (i) is not taken into account on the Calculation Date for the Computation Period during which such gross cash proceeds were actually received by Rouse or any of its subsidiaries, a cumulative 7.5% per annum return, compounded semi-annually, on such amount from the Calculation Date for the Computation Period during which such gross cash proceeds were so received until the Calculation Date for the Computation Period in which such amount is taken into account.

“Howard Hughes Center Management Costs” means, with respect to any Calculation Date, the aggregate amount of direct management costs incurred and
actually paid by Rouse and any of its subsidiaries in connection with the Howard Hughes Center Business Unit during all Computation Periods which have not been taken into account in any prior Computation Period.

“Hughes Funding” means the lesser of (i) the amount funded by Rouse pursuant to the Funding Requirement (as defined below) and (ii) $10,000,000.

“Playa Vista Management Costs” means, with respect to any Calculation Date, the aggregate amount of direct management costs incurred by Rouse and its subsidiaries in connection with the Playa Vista Business Unit during all Computation Periods which have not been taken into account in any prior Computation Period.

“Playa Vista Management Costs Return” means a cumulative 15% per annum return, compounded semi-annually, on the Playa Vista Management Costs from the last day of the Computation Period during which such costs were actually paid by Rouse or any of its subsidiaries until the Calculation Date for the Computation Period in which the amount of such costs is taken into account.

“Rouse Funding” means the amount (not to exceed $5,000,000) funded by Rouse pursuant to the Funding Requirement in excess of $10,000,000.

“Summerlin Business Unit Reduction Amount” means, with respect to any Calculation Date, an amount equal to the sum of (i) 3% of the gross cash proceeds from sales of real estate included in the Summerlin Business Unit during all Computation Periods, reduced by all amounts taken into account in all prior Computation Periods plus (ii) to the extent that all or any portion of the amount under clause (i) is not taken into account on the Calculation Date for the Computation Period during which such gross cash proceeds were actually received by Rouse or any of its subsidiaries, a cumulative 7.5% per annum return, compounded semi-annually, on such amount from the Calculation Date for the Computation Period during which such gross cash proceeds were so received until the Calculation Date for the Computation Period in which such amount is taken into account.

“Underfunded Amount” means the amount of any costs or benefit payments (other than taxes) paid or to be paid or incurred by THC or any of its subsidiaries as the result of the termination of the THC qualified defined benefit plan currently maintained by THC (after all costs that may be paid by such plan are paid by the plan) to the extent such costs or benefit payments are in excess of the reversion amount (before taxes) if any, of such plan on the date of its liquidation, together with interest accruing thereon at the rate of 5% from the date
such costs are incurred or benefit payments made until the date such benefit costs or payments are deducted from the aggregate positive balances of the Business Trust Accounts (see “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Distributions of Contingent Shares Based Upon Cash Flow--Issuance of Contingent Shares” below).

“Valuation Date” means, (i) with respect to the General Business Unit and the portion of the Summerlin Business Unit comprised of Summerlin North, December 31, 2000, (ii) with respect to the Howard Hughes Center Business Unit and the Playa Vista Business Unit, December 31, 2005 and (iii) with respect to the remaining assets of the Summerlin Business Unit, December 31, 2009.

EARNOUT PERIOD; DISTRIBUTION BASED UPON EXCESS CASH FLOW. The Earnout Period for each Business Unit is deemed to have commenced on January 1, 1996 and will continue until the Valuation Date applicable to such Business Unit or portion thereof. Contingent Shares will be issued to the Holders pursuant to a formula for each Business Unit, based upon the Excess Cash Flow of each Business Unit for each Computation Period. The price of the Rouse Common Stock upon which the number of Contingent Shares issuable in respect of any Computation Period will be calculated (the “Current Share Value”) will be the average of the closing prices of Rouse Common Stock on the NYSE Composite Tape (or such other securities exchange or quotation system upon which Rouse Common Stock is then listed or quoted) during the ten trading days prior to the date of computation (the “Computation Date”) consisting of (i) the five consecutive trading days ending on the last day of the calendar month immediately preceding the calendar month in which the Computation Date falls and (ii) the five consecutive trading days ending on the Computation Date.

An amount equal to a percentage of the Excess Cash Flow of each Business Unit will be recorded in a separate account established on the books and records of Rouse (each, a “Business Unit Account”). Each Business Unit Account will be credited with such percentage of the Excess Cash Flow of such Business Unit for each Computation Period. If a Business Unit has Excess Cash Flow, the Holders will be entitled to distributions of Contingent Shares as described below.

(a) GENERAL BUSINESS UNIT ACCOUNT. To the extent that the General Business Unit has Excess Cash Flow for any Computation Period, the Business Unit Account for the General Business Unit will be credited with an amount equal to 50% of such Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 50%), until such Business Unit Account has been credited with an aggregate amount equal to $20,450,000 plus a cumulative return on such amount (or any portion thereof in respect of which such
Business Unit Account has not been previously credited) equal to 15% per annum, compounded semi-annually, from January 1, 1996 to the date that such amount or portion thereof shall have been credited to such Business Unit Account. After the foregoing credits have been made, Excess Cash Flow will first be reduced by an amount equal to the General Business Unit Reduction Amount and thereafter the Business Unit Account for the General Business Unit will be credited with an amount equal to 50% of the remaining Excess Cash Flow.

(b) HOWARD HUGHES CENTER BUSINESS UNIT ACCOUNT. To the extent that the Howard Hughes Center Business Unit has Excess Cash Flow for any Computation Period, (i) such Excess Cash Flow will first be reduced by an amount equal to the lesser of (a) such Excess Cash Flow and (b) the sum of the Howard Hughes Center Management Costs plus, to the extent that such management costs exceeded Excess Cash Flow in prior periods, a cumulative return on such excess of 15% per annum, compounded semi-annually, from the date on which such management costs were incurred to the date on which Excess Cash Flow for the Howard Hughes Center Business Unit for any Computation Period shall have been reduced by such management costs and (ii) thereafter, the Business Unit Account for the Howard Hughes Center Business Unit will be credited with an amount equal to 80% of the remaining Excess Cash Flow; provided, however, that on each Calculation Date, prior to making such credit, the amount of such credit shall be reduced by an amount equal to the aggregate of all amounts paid by Rouse or any of its subsidiaries to Tooley & Company pursuant to that certain Managing Developer Agreement, dated August 15, 1983, among Tooley & Company, THC and HHPLP during all Computation Periods which have not been taken into account in any prior Computation Period.

(c) SUMMERLIN BUSINESS UNIT ACCOUNT. To the extent that the Summerlin Business Unit has Excess Cash Flow for any Computation Period, (i) the Business Unit Account for the Summerlin Business Unit will be credited with an amount equal to 50% of such Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 50%), until such Business Unit Account has been credited with an aggregate amount equal to $32,450,000 plus a cumulative return on such amount (or any portion thereof in respect of which such Business Unit Account has not previously been credited) equal to 15% per annum, compounded semi-annually, from January 1, 1996 to the date that such amount or portion thereof shall have been credited to such Business Unit Account, (ii) thereafter, such Business Unit Account will be credited with an amount equal to 75% of the remaining Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 25%) until such Business Unit Account has been credited with an aggregate amount equal to $40,000,000, (iii) thereafter, such Business Unit Account will be credited with an amount equal
to 25% of the remaining Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 75%) until such Business Unit Account has been credited with an aggregate amount equal to $13,333,333, (iv) thereafter, the remaining Excess Cash Flow will be reduced by an amount equal to the Summerlin Business Unit Reduction Amount and (v) thereafter, such Business Unit Account will be credited with an amount equal to 50% of the remaining Excess Cash Flow.

(d) PLAYA VISTA BUSINESS UNIT ACCOUNT. To the extent that the Playa Vista Business Unit has Excess Cash Flow for any Computation Period, (i) such Excess Cash Flow will first be reduced by an amount equal to the Playa Vista Management Costs and the Playa Vista Management Costs Return, (ii) thereafter, the Business Unit Account for the Playa Vista Business Unit will be credited with an amount equal to 90% of the remaining Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 10%) until such Business Unit Account has been credited with an aggregate amount equal to the Hughes Funding plus a cumulative return on such amount equal to 7% per annum, compounded semi-annually, based on the amount of the Hughes Funding as of the beginning of each prior Computation Period, (iii) thereafter, such Business Unit Account will be credited with an amount equal to 10% of the remaining Excess Cash Flow (with no credit to be made to such Business Unit Account for with the remaining 90%) until such Business Unit Account has been credited with an aggregate amount equal to 1/9th of the Rouse Funding plus a cumulative return on the Rouse Funding equal to 7/9ths of 1% per annum, compounded semi-annually, based on the amount of the Rouse Funding as of the beginning of each prior Computation Period, (iv) thereafter, such Business Unit Account will be credited with an amount equal to 75% of the remaining Excess Cash Flow (with no credit to be made to such Business Unit Account for the remaining 25%) until such Business Unit Account has been credited with an aggregate amount equal to $25,000,000, (v) thereafter, such Business Unit Account will be credited with an amount equal to 25% of the remaining Excess Cash Flow (with no credit made to such Business Unit Account for the remaining 75%) until such Business Unit Account has been credited with an aggregate amount equal to $8,333,333 and (vi) thereafter, such Business Unit Account will be credited with an amount equal to 50% of the remaining Excess Cash Flow.

ISSUANCE OF CONTINGENT SHARES. The number of Contingent Shares issuable for any given Computation Period will be equal to the product of (i) 0.992 times (ii) the sum of (A) an amount equal to (1) the aggregate positive balances of the Business Unit Accounts as of the applicable Calculation Date divided by (2) the Current Share Value plus (B) an amount equal to (1) the Dividend Adjustment (as defined below) divided by (2) the Current Share Value.
Upon delivery by Rouse to the Holders of all Contingent Shares required to be delivered in connection with any Calculation Date, the Business Unit Account with respect to which such Contingent Shares were delivered will be debited by the aggregate value (based on Current Share Value (“Value”)) of the Contingent Shares so delivered. “Dividend Adjustment” means, with respect to any Calculation Date or Valuation Date, an amount equal to the product of (i) the sum of any and all dividends and distributions on a share of Rouse Common Stock having a record date within the period commencing on the applicable Calculation Date or Valuation Date and ending on the date on which the Contingent Shares required to be delivered to the Holders in connection with such Calculation Date or Valuation Date are actually delivered to the Holders times (ii) the number of Contingent Shares which Rouse is otherwise required to deliver to the Holders in connection with such Calculation Date or Valuation Date, as applicable. Rouse is obligated to deliver to each Holder, as soon as practicable and in any event within 60 days after each Calculation Date, that number of Contingent Shares determined by multiplying the aggregate number of Contingent Shares required to be delivered by Rouse on such date by such Holder’s percentage interest under the Contingent Stock Agreement (a “Percentage Interest”). Notwithstanding the foregoing, if an Underfunded Amount exists as of any Calculation Date, the aggregate positive balances of the Business Unit Accounts shall be reduced, prior to calculating the aggregate number of Contingent Shares to be delivered, by an amount equal to the lesser of (i) the aggregate positive balances of the Business Unit Accounts as of such Calculation Date and (ii) the amount of the Underfunded Amount which has not previously been utilized to reduce the aggregate positive balances of the Business Unit Accounts; provided, however, that in no event shall the aggregate amount of such reduction exceed the Underfunded Amount.

DISTRIBUTIONS OF CONTINGENT SHARES BASED UPON APPRAISED VALUE

The Fair Market Value (as defined below) of the assets of each Business Unit or portion thereof will be determined by appraisal as of the Valuation Date with respect to such Business Unit or portion thereof. If Rouse and its subsidiaries own less than 100% of the equity interests of any entity holding assets included in any Business Unit, the Fair Market Value of such assets will be determined by multiplying the Fair Market Value of such entity by the percentage interest owned by Rouse and its subsidiaries, taking into account any preferential rights associated with any equity interests in such entity.

Within five days after the Valuation Date with respect to each Business Unit or portion thereof, the Representatives and Rouse will each appoint one
appraiser for each item of assets included in such Business Unit or portion thereof. Such appraisers will, within five days after the second of them has been appointed, appoint a third appraiser and such appraisers will constitute the “Appraisal Panel” with respect to such item of assets. If the two appraisers appointed are unable to agree on the third appraiser within such five-day period, either the Representatives or Rouse may apply to any court of competent jurisdiction for the appointment of a third appraiser. If either the Representatives or Rouse fails to appoint an appraiser within five days after notice from the other that the recipient of such notice has failed to appoint an appraiser within the five-day period referred to above, the appraiser appointed by the other will be deemed to constitute the Appraisal Panel. Each appraiser must be a real estate and financial expert generally recognized as having current competence in the valuation of assets similar to the assets being appraised in the area(s) where such assets are located. Each appraiser must be independent and, as such, must not be an Associate (as defined in the Contingent Stock Agreement) of Rouse or any Holder (other than as a result of contractual relationships arising out of such appraisal or any prior appraisal pursuant to the Contingent Stock Agreement). The fees and expenses of each Appraisal Panel shall be paid by Rouse.

Each Appraisal Panel will be instructed to determine, within 45 days of its appointment, the Fair Market Value of the Assets comprising the relevant Business Unit or portion thereof as of the relevant Valuation Date. If any Appraisal Panel consists of three appraisers, the Fair Market Value determination that differs the most from the second highest Fair Market Value determination of all three appraisers will be excluded, the remaining two Fair Market Value determinations will be averaged and such average will constitute the determination of the Appraisal Panel. The determination of the Fair Market Value of such Assets by the Appraisal Panel will be final and binding on Rouse, the Holders and the Representatives.

Upon determining the Fair Market Value of the assets comprising any Business Unit or portion thereof, the aggregate Fair Market Value of all of the assets of such Business Unit or portion thereof shall be reduced by an amount equal to the amount of all accounts payable and other indebtedness properly reflected on the records and books of account of such Business Unit or portion thereof in accordance with the terms of the Contingent Stock Agreement which have not been taken into account in determining the percentage of Excess Cash Flow for any Computation Period to be credited to the applicable Business Unit Account of such Business Unit or portion thereof, excluding any such amounts which were taken into account in determining the Fair Market Value of any of such Assets (the “Adjusted Fair Market Value”). Upon determining the Adjusted Fair Market Value of any Business Unit or portion thereof, an amount equal to
such Adjusted Fair Market Value shall be credited to the account of the Holders in the same manner that credits to the Business Unit Account for such Business Unit are calculated, as if such Adjusted Fair Market Value were the Excess Cash Flow upon which such calculations are to be made and taking into account all previous credits which have been made to such Business Unit Account based upon Excess Cash Flow for such Business Unit; provided, however, that (i) such amount shall be determined without regard to any development or management fee otherwise payable to Rouse or any of its subsidiaries, other than any General Business Unit Reduction Amount or Summerlin Business Unit Reduction Amount (which for purposes of such determination shall include 3% of the gross proceeds from sales of real estate comprising the relevant Business Unit or portion thereof prior to such Valuation Date irrespective of whether such proceeds have been received by Rouse or any of its subsidiaries) which represents amounts actually received by or owing to Rouse or any of its subsidiaries which have not previously been taken into account with regard to the sale, prior to the applicable Valuation Date, of any real estate which comprised the General Business Unit or the Summerlin Business Unit and (ii) the amount determined to be credited to the account of the Holders as provided above shall be reduced by an amount equal to 50% of the fees and expenses of each Appraisal Panel which have been paid by Rouse with respect to such Business Unit or portion thereof. “Holders’ FMV Allocation,” when used with reference to the assets of any Business Unit or portion thereof, means the portion of the Adjusted Fair Market Value of such assets allocable to the account of the Holders pursuant to this paragraph.

“Fair Market Value” means, with respect to any asset, the most probable price in terms of money which such asset would bring at a fair sale for its highest reasonable use, determined in a commercially reasonable manner, and where the title to such asset will pass from the seller to the buyer with (i) each of the buyer and the seller acting prudently and knowledgeably, (ii) the price not being affected by any undue stimulus, (iii) neither the buyer nor seller being under compulsion to sell or buy such asset, (iv) each of the buyer and the seller being typically motivated, well informed and advised and acting in what it considers to be its best interests, (v) a reasonable period of time being allowed for exposure of such asset in the open market and (vi) the payment of the purchase price being made in cash. In determining the Fair Market Value of any asset, all liabilities relating to such asset will be taken into account to the extent that they are secured by a lien on such asset or would otherwise encumber such asset in the hands of the buyer, and the appraisers shall assume that the asset being appraised is to be sold in a commercially reasonable manner.

Rouse is obligated to deliver to each Holder (or his or her designee), as soon as practicable and in any event within 12 months after the applicable
Valuation Date, that number of Contingent Shares determined by multiplying (i) the aggregate number of Contingent Shares being delivered by Rouse on such date by (ii) such Holder’s Percentage Interest.

The price of the Rouse Common Stock upon which the number of Contingent Shares issuable in respect of each appraisal will be calculated (the “Valuation Distribution Share Value”) will be the average of the closing prices of Rouse Common Stock on the NYSE Composite Tape (or such other securities exchange or quotation system upon which Rouse Common Stock is then listed or quoted) during the 20 trading days consisting of the five consecutive trading days ending on the last day of each of the four calendar months immediately preceding the calendar month in which the Computation Date falls.

If Rouse delivers all of the Contingent Shares with respect to the Valuation Date for any Business Unit or portion thereof in one installment, the aggregate number of Contingent Shares to be delivered by Rouse shall be determined as of the date such shares are actually delivered to the Holders and shall be a number equal to the product of (i) 0.992 times (ii) the sum of (A) an amount equal to (1) the Holders’ FMV Allocation with respect to such assets divided by (2) the Valuation Distribution Share Value as of such date plus (B) an amount equal to (1) the Dividend Adjustment with respect to the number of Contingent Shares determined under subclause (A) above divided by (2) the Valuation Distribution Share Value as of such date.

If Rouse delivers the Contingent Shares with respect to any Business Unit or portion thereof in more than one installment, on each date on which such shares are actually delivered to the Holders, the “Holders’ FMV Allocation Amount” will be calculated, and will be equal to the product of:

(i) the aggregate number of Contingent Shares being delivered by Rouse on such date times

(ii) the Valuation Distribution Share Value with respect to such date times

(iii) a fraction, the numerator of which is such Valuation Distribution Share Value and the denominator of which is the sum of (A) such Valuation Distribution Share Value plus (B) the Dividend Adjustment with respect to one share of Rouse Common Stock during the period commencing on the applicable Valuation Date to and including such date times
(iv) 0.992.

Rouse shall continue to deliver Contingent Shares to the Holders with respect to such Business Unit or portion thereof until such time as the sum of the Holders’ FMV Allocation Amount with respect to each date on which Rouse delivers Contingent Shares in connection with the Valuation Date for such Business Unit or portion thereof (such date of delivery, a “Valuation Distribution Date”) equals the Holders’ FMV Allocation with respect to such Business Unit or portion thereof. In connection with each such Valuation Distribution Date, Rouse is obligated to deliver to each Holder (or his or her designee) a number of Contingent Shares equal to the product of (i) the aggregate number of Contingent Shares being delivered by Rouse on such Valuation Distribution Date times (ii) such Holder’s Percentage Interest. Rouse is obligated to deliver to each Holder (or his or her designee), as soon as practicable and in any event within 12 months after the applicable Valuation Date, all Contingent Shares required to be delivered with respect to each Business Unit or portion thereof.

FAILURE TO DELIVER CONTINGENT SHARES

In the event that Rouse fails to deliver Contingent Shares on or before any date on which Rouse is obligated to deliver such Contingent Shares (each, a “Delivery Date”), Rouse will be obligated to deliver to each Holder that number of additional Contingent Shares (“Default Shares”) which is equal to the quotient of (i) the return, calculated at the Applicable Federal Rate (as defined in the Contingent Stock Agreement) plus 5%, on an amount equal to (A) the number of Contingent Shares which should have been delivered to such Holder times (B) the Current Share Value utilized to determine the number of Contingent Shares to be delivered by Rouse in connection with the applicable Calculation Date, such return to accrue on such amount for the period commencing on the Delivery Date and continuing thereafter until Rouse delivers such Contingent Shares or Contingent Preferred Shares to such Holder divided by (ii) the Current Share Value utilized to determine the number of Contingent Shares to be delivered by Rouse in connection with the applicable Calculation Date.

ROUSE STOCKHOLDER APPROVAL

Rouse has agreed to use its reasonable best efforts to obtain stockholder approval (the “Rouse Stockholder Approval”) of the Contingent Stock Agreement and the transactions contemplated thereby, prior to July 15, 1997, to the extent that the rules of the NYSE require such approval prior to Rouse issuing new shares of Rouse Common Stock for delivery to the Holders in satisfaction of its obligation to deliver Contingent Shares under the Contingent Stock Agreement. If
the Rouse Stockholder Approval is not obtained, Rouse will issue Contingent Preferred Shares to the extent required under the Contingent Stock Agreement. See “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS-- Contingent Preferred Shares” below.

CONTINGENT PREFERRED SHARES

In the event Rouse is precluded or is otherwise unable to deliver to the Holders shares of Rouse Common Stock on any Delivery Date, including any preclusion or inability resulting from the provisions of Rouse’s listing agreement with the NYSE, Rouse is required to immediately issue and deliver Contingent Preferred Shares. The aggregate number of Contingent Preferred Shares to be issued and delivered on any Delivery Date will be determined by dividing (i) 125% of the sum of (A) the aggregate number of Contingent Shares required to be delivered on the Delivery Date plus (B) the aggregate number of Default Shares by (ii) the quotient of $100 divided by the Current Share Value used in calculating the number of such Contingent Shares. Rouse’s obligation to deliver Contingent Preferred Shares in lieu of Contingent Shares in connection with any such inability or preclusion (but not otherwise) will terminate upon the receipt of the Rouse Stockholder Approval. See “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Covenants of Rouse and the Business Unit Entities” below. For a description of the terms of the Contingent Preferred Shares, see “DESCRIPTION OF ROUSE PREFERRED STOCK-- Increasing Rate Preferred Stock.” In addition, at the option of the Holders, Rouse is required to issue and deliver Contingent Preferred Shares to the Holders upon the happening of certain events described in “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Events of Default” below.

Subject to the terms of the Articles Supplementary to the Rouse Charter creating and designating the Increasing Rate Preferred Stock, Rouse may not amend, alter or otherwise modify such Articles or the number of shares of or the rights, preferences or privileges of the Increasing Rate Preferred Stock thereunder unless (i) in the event that any Contingent Preferred Shares shall have been issued and remain outstanding, such amendment, alteration or the modification shall have been duly approved by the holders of the Contingent Preferred Shares or the Representatives in accordance with the provisions of the Increasing Rate Preferred Stock or (ii) in the event that no Contingent Preferred Shares are issued and outstanding, Rouse shall have obtained the Rouse Stockholder Approval; provided, however, that at any time during which the circumstances described in clause (ii) have been satisfied, Rouse may, without the consent of any Holder or the Representatives, amend such Articles to eliminate the restrictions contained therein with respect to the issuance of any capital stock of Rouse ranking on a
parity with, or senior to, the shares of Increasing Rate Preferred Stock with respect to distributions of assets upon any dissolution, liquidation (partial or complete) or winding up of Rouse or with respect to the payment of dividends.

REVIEW COMMITTEE

The Contingent Stock Agreement contemplates the establishment of a Review Committee which will meet periodically to review and discuss the management, operation and development of the Business Units and their assets. The Review Committee will have five members, two of whom will be designated by Rouse, two by the Representatives and the fifth by the four members previously designated. Members of the Review Committee must be experienced (and generally recognized as competent) in the management and development of residential and commercial properties similar to the assets of the Business Units. Actions of the Review Committee may be taken at a meeting of its members, by which the affirmative vote of a majority of all such members shall be required, or by unanimous written consent. The Review Committee must approve certain major decisions by Rouse with respect to the assets of the Business Units prior to Rouse taking of any action as a result of such decision (see THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Covenants of Rouse and the Business Unit Entities).

REPRESENTATIVES

The Representatives will be appointed as attorneys-in-fact of the Holders to represent the Holders and act on their behalf with respect to matters arising under the Contingent Stock Agreement. Platt W. Davis, III, David G. Elkins and Kenneth E. Studdard have been designated as the initial Representatives. Subject to certain limitations, the Representatives will have the power and authority to interpret and amend the terms of the Contingent Stock Agreement and to compromise and settle disputes between Rouse and the Holders arising under the Contingent Stock Agreement. All actions taken by the Representatives (which shall be taken upon the written direction of majority of the Representatives) will be binding upon the Holders, as if expressly confirmed and ratified by them. Any Representative may be removed at any time, with or without cause, by Holders holding more than 50% of the Percentage Interests. The Representatives will be entitled to compensation for the performance of their duties under, and indemnification against liabilities incurred by them, in connection with the Contingent Stock Agreement.

EVENTS OF DEFAULT
The following events constitute “Events of Default” under the Contingent Stock Agreement: (i) the inaccuracy of any representation, warranty or statement made by Rouse in the Contingent Stock Agreement or in any writing furnished to the Review Committee, any Representative or any Holder as of the date made and in light of the circumstances in which they were made, which inaccuracy, whether alone or together with all other inaccuracies, could reasonably be expected to have a Material Adverse Effect (as defined below); (ii) the breach by Rouse of its obligation to deliver Contingent Shares; (iii) the breach by Rouse of any other material agreement, term or condition of the Contingent Stock Agreement and Rouse’s failure to cure such breach within 30 days after it first became aware of such breach; (iv) the taking of or the omission to take any action by Rouse, which action or omission Rouse knows will result and does result in Rouse’s default of its covenants or agreements in the Contingent Stock Agreement; (v) Rouse or HHPLP makes an assignment for the benefit of creditors or is generally not paying its debts as they become due; (vi) any decree or order for relief in respect of Rouse or HHPLP is entered under any debtor relief law of any jurisdiction; (vii) Rouse or HHPLP files a petition or otherwise applies to any governmental authority for, or consents to, the appointment of, or the taking of possession by, a trustee, receiver, custodian, liquidator or similar official of it or any substantial part of its assets, or commences a voluntary case under any debtor relief law of any jurisdiction; (viii) any such petition or application described in clause (vii) above is filed, or any such proceeding is commenced, against Rouse or HHPLP, and Rouse or HHPLP, as applicable, by any act indicates its approval thereof, consents thereto or acquiesces therein, or an order, judgment or decree is entered appointing any such trustee, receiver, custodian, liquidator or similar official, or approving the petition in any such proceeding, and such order, judgment or decree remains unstayed and in effect for more than 60 consecutive days; (ix) any order, judgment or decree is entered in any proceeding against Rouse or HHPLP decreeing the dissolution, winding-up or liquidation of Rouse or HHPLP, and such order, judgment or decree remains unstayed and in effect for more than 60 consecutive days; (x) any order, judgment or decree is entered in any proceedings against Rouse or HHPLP decreeing a split-up of Rouse or HHPLP, or which requires the divestiture of any material asset or any material portion of the assets of Rouse or HHPLP, and such order, judgment or decree remains unstayed and in effect for more than 60 consecutive days; (xi) the Contingent Stock Agreement at any time, for any reason, ceases to be in full force and effect or is declared to be null and void in whole or in any material part by an order, judgment or decree of any governmental authority, or the validity or enforceability of the Contingent Stock Agreement is contested by or on behalf of Rouse, or Rouse renounces, or denies that it is bound by the terms of, any material provision of the Contingent Stock Agreement; (xii) any violation or breach of, or default under, the governing documents of any Business Unit Entity (as defined below) occurs and (if capable
of being remedied) is not remedied within 30 consecutive days after the date on which such failure first became known to Rouse or such Business Unit Entity, which violation, breach or default, alone or together with all other such violations, breaches and defaults, could reasonably be expected to have a Material Adverse Effect; or (xiii) the failure of Rouse to obtain the Rouse Stockholder Approval prior to July 15, 1997.

“Material Adverse Effect” means a material adverse effect on (i) the business, operations, condition (financial or otherwise), results of operations or prospects of Rouse, any Business Unit Entity or any Business Unit (but excluding the effects of economic, regulatory, tax and other matters of general applicability or matters affecting real estate or the real estate markets (“Independent Factors”)) (ii) Rouse’s ability to perform its obligations under the Contingent Stock Agreement, (iii) the value, condition or marketability of any material assets of any Business Unit (but excluding the effects of Independent Factors), (iv) the validity, legality or enforceability of the Contingent Stock Agreement, (v) the ability of any Holder to exercise or enforce any of its rights, powers or remedies under the Contingent Stock Agreement or (vi) the ability of any Representative or any member of the Review Committee to perform any of its duties or obligations or enforce any of its rights, power or remedies under the Contingent Stock Agreement.

If an Event of Default shall have occurred and be continuing (other than any Event of Default applicable under the circumstances described in the following paragraph), the Representatives may, by notice in writing delivered to Rouse, accelerate the Valuation Date for the Business Units and (i) accelerate Rouse’s obligation to deliver Contingent Shares in connection therewith or (ii) require Rouse, in satisfaction of its obligation to deliver Contingent Shares thereafter, to issue and deliver to the Holders an aggregate number of Contingent Preferred Shares (including fractional shares) determined by dividing (A) the aggregate number of Contingent Shares which would otherwise be delivered to the Holders pursuant to clause (i) by (B) the quotient of (1) $100 divided by (2) the Current Share Value as of the date of such notice. Upon receipt of such notice, Rouse shall cause the appraisals described in “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Distributions of Contingent Shares Based Upon Appraised Value” to be initiated and completed as soon as practicable as of the Calculation Date for the most recent Computation Period ended on or before the date of such notice, and Rouse will be obligated to deliver such Contingent Shares or Contingent Preferred Shares, as applicable, as soon as practicable and in any event within 15 days after the completion of such appraisals.
If (i) but for the provisions described under “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Limitation on Covenants and Agreements,” an Event of Default described in clause (iii) of the definition thereof would have occurred and be continuing with respect to any Business Unit Entity solely on account of the non-performance by Rouse of any of its covenants relating to compliance with laws, payment of taxes and claims, maintenance of insurance and preservation of corporate existence, as such covenant relates to such Business Unit Entity and (ii) in connection with such circumstances, (A) Rouse shall have determined in good faith that it would neither be commercially reasonable nor in the best interests of Rouse and the Holders for Rouse to take, or cause to be taken, the actions necessary to avoid such non-performance and (B) Rouse shall have given prior written notice of such non-performance to the Representatives, then the Representatives may, by notice in writing delivered to Rouse, (1) accelerate Rouse’s obligation to deliver Contingent Shares with respect to the assets of the Business Unit to which such non-performance relates or (2) require Rouse, in satisfaction of its obligation to deliver Contingent Shares thereafter with respect to the assets comprising the Business Unit to which such non-performance relates, to issue and deliver to the Holders an aggregate number of Contingent Preferred Shares (including fractional shares) determined by dividing (x) the aggregate number of Contingent Shares which would otherwise be delivered to the Holders under clause (1) above by (y) the quotient of (I) $100 divided by (II) the Current Share Value as of the date of such notice. Upon receipt of such notice, Rouse shall cause the appraisals described in “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Distributions of Contingent Shares Based Upon Appraised Value” to be initiated and completed with respect to such assets as soon as practicable as of the Calculation Date for the most recent Computation Period ended on or before the date of such notice, and Rouse will be obligated to deliver such Contingent Shares or Contingent Preferred Shares, as soon as practicable and in any event within 15 days after the completion of such appraisals; provided, however, that in connection with any appraisal conducted pursuant to this paragraph, the Appraisal Panel will be instructed to determine the Fair Market Value of the relevant assets as if no person is required to make any additional contribution to the capital of, or investment in, or loan or advance in respect of, such assets.

If any foreclosure on, or the exercise of any similar remedy with respect to, any of the assets comprising any Business Unit shall occur or (i) an Event of Default described in clause (v), (vi), (vii), (viii), (ix) or (x) of the definition thereof shall have occurred and be continuing with respect to any Business Unit Entity other than HHPLP, as if such clauses applied to each such Business Unit Entity instead of Rouse and HHPLP and (ii) if, in connection with such Event of
Default, (A) Rouse shall have determined in good faith that it would neither be commercially reasonable nor in the best interests of Rouse and the Holders for Rouse to take, or cause to be taken, the actions necessary to avoid such Event of Default and (B) Rouse shall have given prior written notice of such Event of Default to the Representatives, then, in any such event the Representatives may, by notice in writing delivered to Rouse, (1) accelerate Rouse’s obligation to deliver Contingent Shares with respect to any assets of any Business Unit which are owned by such Business Unit Entity or (2) require Rouse, in satisfaction of Rouse’s obligation to deliver Contingent Shares thereafter with respect to any assets comprising any Business Unit which are owned by such Business Unit Entity, to issue and deliver to the Holders an aggregate number of Contingent Preferred Shares (including fractional shares) determined by dividing (x) the aggregate number of Contingent Shares which would otherwise be delivered to the Holders under clause (1) above by (y) the quotient of (I) $100 divided by (II) the Current Share Value as of the date of such notice. Upon receipt of such notice, Rouse shall cause the appraisals described in “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Distributions of Contingent Shares Based Upon Appraised Value” to be initiated and completed with respect to such assets as soon as practicable as of the Calculation Date for the most recent Computation Period ended on or before the date of such notice, and Rouse will be obligated to deliver such Contingent Shares or Contingent Preferred Shares, as soon as practicable and in any event within 15 days after the completion of such appraisals; provided, however, that in connection with any appraisal conducted pursuant to this paragraph, the Appraisal Panel will be instructed to determine the Fair Market Value of the relevant assets as if no person is required to make any additional contribution to the capital of, or investment in, or loan or advance in respect of, such assets.

COVENANTS OF ROUSE AND THE BUSINESS UNIT ENTITIES

During the Earnout Period for each Business Unit, Rouse will cause the assets of such Business Unit to be maintained at all times in (i) HHPLP or (ii) with the prior written consent of the Representatives, a separate partnership or corporation directly or indirectly wholly owned by Rouse (each, a “Business Unit Entity”). During the Earnout Period, the assets of the Business Units will be developed and operated separately from other assets of Rouse.

Under the Contingent Stock Agreement, without the prior written consent of a majority of the members of the Review Committee, Rouse shall not permit or cause any Business Unit Entity to, directly or indirectly: (i) transfer in bulk more than 500 acres of real estate comprising any Business Unit; (ii) borrow or otherwise become obligated in respect of any indebtedness in excess of (A)
$10,000,000 with respect to the General Business Unit, (B) $5,000,000 with respect to the Howard Hughes Center Business Unit, (C) zero with respect to the Playa Vista Business Unit or (D) $75,000,000 plus the amount of any special improvement district financings with respect to the Summerlin Business Unit; (iii) create, incur or permit to exist any lien upon any of the assets comprising any Business Unit (other than permitted encumbrances), except in connection with a financing where the proceeds of such financing will be used exclusively for the development or operation of such assets; (iv) engage in the development of amenities in connection with the assets comprising any Business Unit where the reasonably anticipated costs and expenses of such development will exceed $10,000,000 (other than infrastructure required by law or pursuant to any governmental approval in order to permit development which would not otherwise be subject to Review Committee approval); (v) make any premature infrastructure expenditures or any other infrastructure expenditures which are excessive when considered in light of the projected schedule for development of the assets of the Business Unit to which such infrastructure relates; (vi) consolidate with or merge into any person or permit any person to consolidate with or merge into such Business Unit Entity, sell all or substantially all of the assets comprising any Business Unit or dissolve or liquidate; or (vii) generally not pay, or admit in writing its inability to pay, its debts as they mature, make a general assignment for the benefit of creditors, institute any proceeding under any debtor relief law seeking to adjudicate itself insolvent, seeking liquidation, winding-up, reorganization, arrangement, adjustment, protection, relief or composition of it or its debts, or seeking the entry of an order for relief or the appointment of a receiver, trustee or other similar official for it or for any substantial part of its assets, or take any action similar official for it or for any substantial part of its assets, or any action in furtherance of any such actions or, in any involuntary proceeding under any debtor relief law, by any act indicate its approval of such proceedings, its consent thereto or its acquiescence therein.

In addition, without the prior consent of majority of the members of the Review Committee, Rouse shall not, and shall not permit or cause any Business Unit Entity to, directly or indirectly: (i) permit any assets comprising any Business Unit to be subject to the claims of creditors of Rouse, any Business Unit Entity or any of their respective affiliates except for (A) claims arising directly from the operation or ownership of such assets in the ordinary course of business in compliance with the provisions of the Contingent Stock Agreement and (B) claims of any person that is not an Associate of Rouse or any Business Unit Entity (other than persons that are Associates of Rouse or any Business Unit Entity solely due to the contractual relationships under the applicable contract), arising under any contract pursuant to which such person provides products or services to (x) the applicable Business Unit Entity in connection with the assets comprising
such Business Unit and (y) Rouse, any other Business Unit Entity or such Business Unit Entity in connection with its other operations, or any of their respective affiliates, and other claims arising by operation of law, to the extent that such claims are being contested in good faith by appropriate proceedings promptly initiated and diligently conducted, but only if adequate reserves have been established on the books of Rouse in connection with such claims in accordance with generally accepted accounting principles; (ii) enter into or permit to exist any contract, including any financing agreement or arrangement, joint venture agreement or partnership agreement, which precludes or places any material conditions or restrictions on the rights or ability of Rouse or any Business Unit Entity to (A) make any payment or transfer or perform any act required under the terms of the Contingent Stock Agreement or (B) manage or develop the assets comprising any Business Unit in the ordinary course, including pursuant to any non-competition covenant, restriction on capital expenditures or indebtedness or restriction on transactions with affiliates contained in any such contract; (iii) enter into any transaction with any of its subsidiaries, affiliates or Associates (other than persons that will become Associates solely as a result of such transaction) which (A) involves any of the Business Units or any of the assets comprising any Business Unit, other than transactions entered into the ordinary course of business on terms no less favorable than those that could be obtained in an arm’s-length transaction with a person that is not an Associate of Rouse or any Business Unit Entity, or (B) could reasonably be expected to result in a material adverse effect on (1) Rouse’s ability to perform its obligations under the Contingent Stock Agreement, (2) the value, condition or marketability of any assets comprising any Business Unit, (3) the validity, legality, or enforceability of the Contingent Stock Agreement, (4) the ability of any Holder to exercise or enforce any of its rights, powers or remedies under the Contingent Stock Agreement or (5) the ability of any Representative or any member of the Review Committee to perform any of his or her duties or obligations, or to exercise or enforce any of his or her rights, powers or remedies, under the Contingent Stock Agreement; or (iv) enter into any transaction involving competition in any material respect with any Business Unit or the assets comprising any Business Unit; provided, however, that the purchase by Rouse from HHPLP of certain assets of the Summerlin Business Unit for the purpose of constructing and operating for the foreseeable future a regional shopping mall and entertainment complex thereon will not, in and of itself, be deemed to involve competition between Rouse and the Summerlin Business Unit.

Notwithstanding the foregoing, no transaction described in the two preceding paragraphs shall require the consent of the Review Committee if and to the extent that such transaction has been duly approved by the THC Board prior to the Effective Time; provided, however, that any such transaction which is
described in clause (ii) of the second preceding paragraph shall be taken into account in determining whether the applicable Business Unit has borrowed or otherwise become obligated with respect to indebtedness in excess of the relevant amount.

Under the Contingent Stock Agreement, Rouse acknowledges and agrees that it is accountable as a fiduciary to the Holders and their respective executors, personal representatives, administrators, successors, heirs, distributees, devisees, legatees and permitted assigns, which fiduciary duty shall be the same as the fiduciary duty owed by a director of a corporation to the stockholders of such corporation. Without limitation of the foregoing, Rouse shall, and shall cause each Business Unit Entity to, (i) exercise reasonable care and act with good faith and integrity in managing and operating the Business Units and the assets comprising the Business Units and (ii) deal with the Holders and the Representatives fairly and in good faith.

LIMITATION ON COVENANTS AND AGREEMENTS

Except as described under “THE CONTINGENT STOCK AGREEMENT; THE CONTRACTUAL RIGHTS--Capitalization of Business Units,” no obligation or covenant imposed by the Contingent Stock Agreement shall be construed to obligate Rouse or any of its subsidiaries in any way to make loans to, advance funds to, invest additional capital in or extend its credit in order to obtain financing for, or provide working capital for, any Business Unit or any Business Unit Entity, except in its sole and absolute discretion. Rouse makes no representation or warranty that the operation of any Business Unit or any portion of the assets of any Business Unit shall be profitable or that any Business Unit will have receipts sufficient to obligate Rouse to deliver Contingent Shares under the Contingent Stock Agreement.

CAPITALIZATION OF BUSINESS UNITS

Except as described below, Rouse and its subsidiaries have no obligation to provide funds to any Business Unit in connection with the conduct of the business and operations of such Business Unit.

PLAYA VISTA. To the extent that HHPLP (or any Business Unit Entity succeeding to the interests of HHPLP in the assets of the Playa Vista Business Unit), together with Maguire Thomas Partners/JMB Associates and Maguire Thomas Partners/JMB Area C Associates (collectively, the “PV General Partners”), determine to contribute additional capital to either of the PV Partnerships, Rouse will make contributions on behalf of HHPLP in an amount
not to exceed $15,000,000 (the “Funding Requirement”); provided that Rouse will not be obligated to make any such contribution unless (i) with respect to all or any portion of the first $10,000,000 of the Funding Requirement, a majority of the members of the Review Committee determine that Rouse should make such contribution and (ii) with respect to all or any portion of the Funding Requirement in excess of $10,000,000, all of the members of the Review Committee determine that Rouse should make such contribution. Any capital contributions made to the PV Partnerships during the period commencing on January 1, 1996 to and including the Effective Time will be deemed to have been made by Rouse. If Rouse funds less than $10,000,000 pursuant to the Funding Requirement, on or before the tenth day after the Termination Date (as defined below), the Business Unit Account for the Playa Vista Business Unit will be credited with an amount equal to the sum of (A) $10,000,000 minus the amount of the Hughes Funding plus (B) a 7% per annum return, compounded semi-annually, on such amount from the date of the Contingent Stock Agreement to date such amount is credited to the Business Unit Account for the Playa Vista Business Unit. “Termination Date” means the date of consummation of the Playa Vista Financings (as defined in the Contingent Stock Agreement) (see “THE HUGHES CORPORATION--Los Angeles Properties--Playa Vista”) or, if such financings are not consummated, at such time as the agreements, if any, between HHPLP and Maguire Thomas Partners for mutually agreed capital commitments expire or are terminated.

OTHER BUSINESS UNITS. From the Effective Time until nine months after the Effective Time, Rouse shall, from time to time make a loan or loans to the Business Unit Entities owning the assets of the General Business Unit, the Howard Hughes Center Business Unit and the Summerlin Business Unit, on a revolving credit basis, in an aggregate principal amount not at any time exceeding $25,000,000 (the “Revolving Credit Loans”); provided, however, that if, on the date which is nine months after the date on which the Effective Time occurs (the “Effective Date”), the unutilized portion of the commitment under the working capital component of the Bank of America credit facility currently available to HHPLP, or any replacement facility, is less than $20,000,000, then Rouse shall continue to, from time to time, make Revolving Credit Loans to such Business Unit Entities until the date which is two years after the Effective Date, in an aggregate principal amount not at any time exceeding $20,000,000 minus the unutilized portion of such commitment on the date which is nine months after the Effective Date. In no event will Rouse be obligated to make loans unless the applicable Business Unit Entity could not reasonably be expected to obtain funds for working capital requirements through borrowing from a financial institution on commercially reasonable terms. The proceeds of each Revolving Credit Loan will be used solely (i) for working capital purposes of the relevant Business Unit and (ii) in connection with the operation of the relevant Business Unit. If the
aggregate working capital requirements of two or more Business Units exceed $25,000,000 at any time, the Revolving Credit Loans may be allocated by Rouse among such Business Units as Rouse reasonably determines in good faith.

On each Calculation Date occurring while any Revolving Credit Loan is outstanding, the working capital needs of the General Business Unit, the Howard Hughes Center Business Unit and the Summerlin Business Unit will be reviewed. If Excess Cash Flow exceeds funds required by a Business Unit for working capital purposes, such excess shall be used to repay outstanding amounts under Revolving Credit Loans made for the account of such Business Unit, and thereafter to repay outstanding amounts under Revolving Credit Loans made for the account of other Business Units. To the extent that a Revolving Credit Loan made for the account of a Business Unit is paid for the account of a different Business Unit, such payment shall constitute an Advance (as defined below) by the Business Unit for whose account such payment was made to the Business Unit for whose account such Revolving Credit Loan was borrowed and a payment by the Business Unit Entity for whose account such Revolving Credit Loan was borrowed to Rouse.

LOANS AND ADVANCES

Rouse may, at its option, make loans and advances to any Business Unit Entity for the account of any Business Unit from time to time for the sole purpose of providing working capital and other funds for use in connection with such Business Unit as contemplated by the Contingent Stock Agreement (each a “Loan”); provided, however, that prior to making any Loan, Rouse will pay or cause to be paid in cash any payables owed to such Business Unit by Rouse or any affiliate of Rouse, irrespective of whether the same are due and payable. To the extent that any Business Unit requires funds for such purposes, Rouse may, at its option, (i) cause the applicable Business Unit Entity to borrow such funds for the account of such Business Unit from a financial institution on commercially reasonable terms or (ii) make a Loan to such Business Unit Entity for the account of such Business Unit on arm’s length terms provided that if such Business Unit Entity could not reasonably be expected to obtain such funds through a borrowing from a financial institution at a per annum interest rate of less than 15%, than such Loan shall accrue interest at the rate of 15% per annum.

If (i) any Business Unit has insufficient funds for working capital purposes; (ii) Rouse is not obligated to make a Revolving Credit Loan to the applicable Business Unit Entity; (iii) third party financing to fund such working capital requirements is unavailable to such Business Unit Entity; and (iv) Rouse elects not to make a Loan to such Business Unit Entity for the account of such
Business Unit, such Business Unit Entity or any other Business Unit Entity may, with the unanimous consent of the Review Committee, loan funds to such Business Unit from any other Business Unit (each such loan, an “Advance”); provided, however, that prior to any Advance being made to such Business Unit, Rouse will pay or cause to be paid in cash any payables owed to such Business Unit by Rouse or any affiliate of Rouse, irrespective of whether the same are due and payable. Advances shall not bear any interest and shall be repaid by the recipient Business Unit to the Business Unit making such Advance on each Calculation Date thereafter, to the extent that the Excess Cash Flow of such Business Unit as of such Calculation Date exceeds its working capital requirements after giving effect to any payments required to be made to Rouse in respect of Revolving Credit Loans. The proceeds of an Advance are deemed to be a receipt by the Business Unit receiving such Advance and an expenditure by the Business Unit making such Advance for purposes of determining Excess Cash Flow for such Business Units for the Computation Period during which such Advance is made.

ABANDONMENT OF ASSETS

If (i) Rouse, in its good faith judgment, determines, based upon reasonable assumptions and after consultation with the Review Committee, that the continued ownership and operation of any Business Unit would be neither profitable to nor in the best interests of Rouse and the Holders; (ii) Rouse is not obligated to make a Revolving Credit Loan to the applicable Business Unit Entity; (iii) third party financing to fund the cash requirements of such Business Unit is unavailable to the applicable Business Unit Entity; (iv) Rouse is unwilling to make a Loan to the applicable Business Unit Entity in connection with such Business Unit; and (v) the Review Committee has rejected a request to have another Business Unit make an Advance to such Business Unit, then Rouse may cease to operate such Business Unit; provided, however, that prior to any such cessation, Rouse shall (A) unless otherwise consented to by the Representatives, use commercially reasonable efforts for a period of at least 12 months to market and sell or lease the assets of such Business Unit and (B) if no potential purchaser or lessee for any of such assets exists as of the last day of such period, Rouse shall, unless otherwise consented to by the Representatives, sell any such assets at a public auction, for cash or credit, at the highest price bid for such assets at such auction.

BOARD REPRESENTATION

From the date of the Contingent Stock Agreement until the earlier to occur of (i) the first day on which the Holders will no longer own, beneficially or of
record, at least 5% of the outstanding shares of Rouse Common Stock and (ii) the expiration of ten years from the date of the Contingent Stock Agreement, the Representatives will be entitled to designate an individual for election to the Board of Directors of Rouse; provided, however, that such individual is reasonably acceptable to Rouse at the time of his other initial designation.

Pursuant to the terms of the THC Merger Agreement, in accordance with its bylaws, the Board of Directors of Rouse, at its February 22, 1996 meeting, determined to increase the size of its Board of Directors by one and to fill the vacancy created by such increase by the election of the Holders’ Designee (i.e., William R. Lummis), which election will be effective as of the Effective Time. See “MANAGEMENT OF ROUSE--Addition of Director and Executive Officer as a Result of the Mergers.” Such Holders’ Designee shall serve until the first annual meeting of the stockholders of Rouse following the Effective Time and until his or her successor shall be duly elected and qualified or until his or her death, disability, removal or resignation.

So long as the Representatives possess the right of designation described above, Rouse will nominate (or will cause to be nominated) for election at each annual meeting of the stockholders of Rouse after the Effective Time, the incumbent Holders’ Designee or such other individual as the Representatives may designate; provided, however, that such other individual is reasonably acceptable to Rouse at the time of his or her initial designation.

So long as the Representatives possess the right of designation described above, if the Holders’ Designee should die, become disabled, be removed, retire or resign during the term of his or her office, the Representatives will be entitled to designate a successor Holders’ Designee reasonably acceptable to Rouse at the time of his or her initial designation, in which event Rouse will cause such successor Holders’ Designee to be promptly elected as a member of the Board of Directors of Rouse to fill the vacancy created by such death, disability, removal, retirement or resignation. So long as the Representative possess the right of designation described above, without the prior written consent of the Representatives (which consent will not be unreasonably withheld), neither Rouse nor its Board of Directors will (i) recommend that the Holders’ Designee be removed by the stockholders of Rouse or (ii) fail to recommend any incumbent Holders’ Designee for re-election.

REPRESENTATIONS AND WARRANTIES

Rouse makes certain representations and warranties in the Contingent Stock Agreement relating to, among other things: (i) organization and qualification to do business; (ii) authorization, execution, delivery, performance
and enforceability of the Contingent Stock Agreement and the absence of conflicts, violations and defaults as a result thereof under charters and bylaws, statutes, rules and regulations, judgments, orders and decrees and certain agreements; (iii) receipt of all necessary approvals and consents from governmental authorities; (iv) due authorization and valid issuance of the Contingent Shares and Contingent Preferred Shares at the time of issuance; (v) free tradeability of the Contingent Shares upon receipt; (vi) effectiveness of the Registration Statement (of which this Proxy Statement/Prospectus constitutes a part); (vii) registration of the Contingent Shares and the Contingent Preferred Shares under state securities laws; (viii) absence of certain claims, demands or proceedings; (ix) absence of any judgments, orders, injunctions or decrees that would have a material adverse effect on Rouse’s ability to perform its obligations under the Contingent Stock Agreement, the value or marketability of the assets of the Business Units and other matters; and (x) accuracy and completeness of any factual information provided by Rouse or any Business Unit to the Holders or their agents.

FINANCIAL AND OTHER INFORMATION TO BE PROVIDED BY ROUSE

Rouse is required to furnish to the Review Committee and the Representatives as soon as available (and in any event not later than 60 days) after the end of each Computation Period: (i) a report prepared and certified by an authorized officer with respect to each Business Unit, prepared as of the last day of such Computation Period, setting forth the amount and purpose of each reserve established and/or maintained by Rouse or any Business Unit Entity with respect to any of the Business Units accompanied by a certificate of such authorized officer stating (A) that all such reserves comply with and satisfy the definition of “Reserve” contained in the Contingent Stock Agreement and (B) whether or not during or at the end of such Computation Period any Event of Default existed and, if any Event of Default existed, specifying the nature and period of existence thereof and what action Rouse or such Business Unit Entity has taken, is taking or proposes to take with respect thereto; (ii) a report prepared and certified by an authorized officer with respect to each Business Unit, prepared as of the last day of such Computation Period (A) specifying (1) receipts received by Rouse, any Business Unit Entity or any of their respective subsidiaries during such Computation Period with respect to such Business Unit and the aggregate amount of receipts received by Rouse, any Business Unit Entity or any of their respective subsidiaries during the period from the effective date of the Contingent Stock Agreement to and including the last day of such Computation Period with respect to such Business Unit, (2) expenditures incurred by Rouse, any Business Unit Entity or any of their respective subsidiaries during such Computation Period with respect to such Business Unit and the aggregate amount of any and all
expenditures incurred by Rouse, any Business Unit Entity or any of their respective subsidiaries during the period from the effective date of the Contingent Stock Agreement to and including the last day of such Computation Period with respect to such Business Unit and (3) the amount of Excess Cash Flow with respect to such Business Unit as of the last day of such Computation Period and the aggregate amount of Excess Cash Flow during the period from the effective date of the Contingent Stock Agreement to and including the last day of such Computation Period with respect to such Business Unit and (B) showing in reasonable detail the manner in which such amounts were calculated; and (iii) except after the last Computation Period of any calendar year, an operating statement with respect to each Business Unit for such Computation Period and the portion of the calendar year then ended, together with a certificate of an authorized officer stating that such operating statement has been prepared (A) in accordance with generally accepted accounting principles and (B) using such allocations, conventions and methods as are consistent with generally accepted accounting principles and have been consistently utilized by Rouse or the applicable Business Unit Entity with respect to such Business Unit.

Rouse is required to furnish to the Review Committee and the Representatives as soon as available (and in any event not later than 120 days) after the end of each calendar year, an operating statement with respect to each Business Unit for such calendar year, together with a certificate of an authorized officer stating that such operating statement has been prepared (i) in accordance with generally accepted accounting principles and (ii) using such allocations, conventions and methods as are consistent with generally accepted accounting principles and have been consistently utilized by Rouse or the applicable Business Unit Entity with respect to such Business Unit.

In addition, Rouse is required to provide the Review Committee and the Representatives with prompt notice of (i) the occurrence of any Event of Default and any proposed action with respect thereto, (ii) any violation of any licenses, permits, registrations, exemptions, franchises or other authorizations or consents obtained from governmental authorities in connection with the Business Units and any amendment or revocation thereof if such violation or amendment or revocation could reasonably be expected to have a Material Adverse Effect, (iii) any violation of, or noncompliance with remedial obligations under, any environmental statute to which the Business Units or any of their assets are subject or any contamination of the environment if such violation or contamination could reasonably be expected to have a Material Adverse Effect, (iv) the existence of any claim, demand or proceeding with respect to matters (including violations of environmental statutes and releases of hazardous materials into the environment) affecting any Business Unit if such claim, demand
or proceeding could reasonably be expected to have a Material Adverse Effect and (v) the incurrence of any lien (or the taking of any action leading thereto) on the assets of any Business Unit if such lien could reasonably be expected to have a Material Adverse Effect. Rouse will also provide the Review Committee and the Representatives with (i) copies of all periodic reports, proxy statements and registration statements that it files with the Commission or any national securities exchange, and (ii) copies of all press releases and other written statements it makes available to the public relating to the Business Units or any of their assets or to any event, circumstance or condition which could reasonably be expected to have a Material Adverse Effect.

CONSOLIDATION AND MERGERS; SUCCESSORS

Rouse will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of Rouse, by agreement in form and substance reasonably acceptable to the Representatives, to expressly assume and agree to perform the Contingent Stock Agreement in the same manner and to the same extent that Rouse would be required to perform it if no such succession had taken place.

In the Contingent Stock Agreement, Rouse acknowledges that such agreement and the rights of the Holders thereunder (including (i) the right of the Holders to receive securities which are freely tradeable and readily marketable and (ii) the non-taxable receipt by the Holders of Rouse Common Stock pursuant to the THC Merger and of Contingent Shares or Contingent Preferred Shares thereunder) are of major importance to the Holders and that each Holder is justified in believing and assuming that Rouse will not voluntarily undertake or complete any Prohibited Transaction (as defined below) and Rouse agrees that, without the prior written consent of the Majority Holders (as defined below), it will not undertake or complete any Prohibited Transaction. “Prohibited Transaction” means (A) any reorganization of Rouse or any consolidation or merger of Rouse with or into another entity, (B) any recapitalization, reclassification or change in the capital structure of Rouse, (C) any partial or complete liquidation, dissolution or winding up of the affairs of Rouse or (D) any other transaction or event if, in any such case and for any reason, (1) Rouse or any successor to Rouse shall be incapable of, or restricted or prohibited from, delivering (on a timely basis) freely tradeable and readily marketable securities comparable to the Contingent Shares or the Contingent Preferred Shares (as applicable) or (2) such transaction or event could reasonably be expected to have a prejudicial effect on the Holders with respect to their non-taxable receipt of securities pursuant to the THC Merger Agreement or the Contingent Stock Agreement.
In the event Rouse desires to implement any transaction of the type described in clauses (A) through (D) of the preceding paragraph which Rouse has concluded, in good faith, does not constitute a Prohibited Transaction (a “Proposed Transaction”), Rouse shall, as soon as practicable prior to the implementation of the Proposed Transaction, give written notice to the Representatives describing the Proposed Transaction in reasonable detail and setting forth Rouse’s conclusion that the Proposed Transaction does not constitute a Prohibited Transaction and the reasons therefor. Such notice may also contain a request that the Representatives agree with the conclusion set forth therein. Upon receipt of any such request, the Representatives shall consider the same in good faith and shall be authorized (but not obligated) to agree, on behalf of the Holders, with Rouse’s conclusion that the Proposed Transaction does not constitute a Prohibited Transaction. Any such agreement of the Representatives (i) shall be in writing, (ii) shall be limited to the Proposed Transaction in question and shall not extend or apply to any other transaction or event and (iii) may be conditioned upon and subject to the execution and delivery to the Representatives of one or more instruments in writing designed to fairly and equitably protect the rights, privileges, interests and remedies of the Holders and the Representatives against one or more effects of the Proposed Transaction. Moreover, each such agreement of the Representatives shall be binding upon the Holders and, in the absence of fraud or bad faith, Rouse shall be fully protected in acting in accordance with such agreement.

DISPUTE RESOLUTION

In the event of any dispute between Rouse, on the one hand, and the Representatives, on the other hand, with respect to any matter covered by the Contingent Stock Agreement, Rouse and the Representatives (the “Disputants”) shall first use their best efforts to resolve such dispute between themselves. If the Disputants are unable to resolve the dispute within 15 days, they agree to submit the dispute to mediation in accordance with the Commercial Mediation Rules of the American Arbitration Association. The Disputants will jointly appoint a mutually acceptable mediator, seeking assistance from the American Arbitration Association if they are unable to agree upon such appointment within ten days following the 15-day period referred to above. Upon appointment of the mediator, the Disputants agree to participate in good faith in the mediation and negotiations relating thereto for 20 days. If the Disputants are not successful in resolving the dispute through mediation within such 20-day period, either Disputant may submit the dispute to arbitration. The fees and expenses of the mediator shall be borne by the non-prevailing party or, in the event there is no clear prevailing party, as the mediator deems appropriate. To submit a dispute to arbitration, a
Disputant must give written notice to the other Disputant, in which event the dispute shall be settled by arbitration. The fees and expenses of the arbitrators shall be borne by the non-prevailing Disputant or, in the event there is no clear prevailing Disputant, as the arbitrators deem appropriate. All arbitration conferences and hearing shall be held in Wilmington, Delaware or at such other place as the Disputants may mutually agree.

AMENDMENTS AND WAIVER

The Contingent Stock Agreement may not be amended, supplemented or modified, nor may compliance by Rouse with any provision of the Contingent Stock Agreement be waived (either generally or in a particular instance and either retroactively or prospectively), except, in each case, by an instrument in writing duly entered into by Rouse and all of the Representatives. Without limitation of the foregoing, the Representatives may, without the consent of any of the Holders, enter into one or more instruments supplemental to the Contingent Stock Agreement as they may deem desirable in order to (i) add to the covenants of Rouse in the Contingent Stock Agreement, (ii) surrender any right or power conferred upon Rouse by the Contingent Stock Agreement, (iii) evidence any succession of any person to Rouse and the assumption by such successor of the covenants of Rouse contained in the Contingent Stock Agreement, (iv) cure any ambiguity in (or cure, correct or supplement any defective provision of) the Contingent Stock Agreement in such manner as shall not be inconsistent with the Contingent Stock Agreement or adversely affect the rights, privileges or remedies of the Holders under the Contingent Stock Agreement. Notwithstanding the foregoing, no such amendment, supplement, modification or waiver will be effective:

(A) except as provided in clause (B) below, without the prior written consent of Holders whose combined Percentage Interests represent more than 50% of the Percentage Interests of all Holders (excluding Rouse, its subsidiaries and affiliates (the “Majority Holders”), if such amendment, supplement, modification or waiver would (1) add any provision to the Contingent Stock Agreement, change in any manner or eliminate any of the provisions of the Contingent Stock Agreement or modify in any respect the rights of the Holders under the Contingent Stock Agreement, in each case if such addition, change, elimination or modification would materially and adversely affect the rights, privileges or remedies of the Holders under the Contingent Stock Agreement or (2) waive any Event of Default;
(B) without the prior written consent of all the Holders, if such amendment, supplement, modification or waiver would (1) change the amount of, or times for the delivery of, Contingent Shares or Contingent Preferred Shares to be delivered by Rouse under the Contingent Stock Agreement in a manner adverse to the Holders, (2) change the Valuation Date of any Business Unit, (3) reduce the Percentage Interest of any Holder (other than due to an assignment to a permitted assignee), (4) substitute any equity interest for the Contingent Shares or Contingent Preferred Shares required to be delivered by Rouse under the Contingent Stock Agreement (unless otherwise specifically permitted in the Contingent Stock Agreement), (5) waive any Event of Default under clause (ii) of the definition thereof or (6) change the provisions of the Contingent Stock Agreement with respect to amendments, supplements, modifications and waivers (except to increase any percentage required to approve any such amendment, supplement, modification or waiver or to provide that certain other provisions of the Contingent Stock Agreement cannot be amended, supplemented, modified or waived without the consent of all of the Holders affected thereby);

(C) without the prior written consent of all members of the Review Committee, if such amendment, supplement, modification or waiver would adversely affect the rights, duties or immunities of the members of the Review Committee under the Contingent Stock Agreement; or

(D) without the prior written consent of all of the Representatives, if such amendment, supplement, modification or waiver would adversely affect the rights, duties or immunities of the Representatives under the Contingent Stock Agreement.

Notwithstanding anything to the contrary contained in the Contingent Stock Agreement, Article V of the Contingent Stock Agreement (relating to the Representatives) may be amended, supplemented or modified at any time solely by an instrument in writing signed (x) by the Representatives with the consent of the Majority Holders and (y) if and to the extent that such amendment, modification or supplement would in any way be prejudicial to Rouse, by Rouse.