

# The Challenge of Earnout Provisions In Acquisition Agreements

By

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The recent case of *Horizon Holdings, LLC v. Genmar Holdings, Inc.*<sup>1</sup> is a reminder of the challenge of negotiating, drafting and implementing so-called “earnout” arrangements in acquisition transactions. In *Horizon Holdings*, the 10th Circuit upheld a jury award to the seller of a manufacturer business who the jury believed was deprived by the buyer of an opportunity to achieve the earnout even though the actions taken by the buyer were not prohibited in the agreement. The Court, applying Delaware law, invoked concepts of good faith and fair dealing to find the jury could reasonably conclude the seller and buyer would have included certain terms in the acquisition contract which would have addressed the actions taken by the buyer had they thought about them in their negotiations.

Earnouts can be advantageous to buyers and sellers when they negotiate the acquisition of a target business. An inherent asymmetry of information exists between a buyer and seller on the valuation of a target business and the future profitability of the combined entity post-closing. Seller and buyer will not equally assess these issues in the same way and they become more acute with a target private company which does not benefit from existing market valuations. Earnout arrangements allocate these risks between the buyer and seller by paying value to the seller if the acquired business meets prescribed performance measures post-closing. As articulated in *Horizon Holdings*, however, earnout provisions may create unanticipated problems not recognized until after the acquisition has closed. This article explores various issues that

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<sup>1</sup> 387 F3d 1188 (10th Cir 2004).

buyers and sellers should consider when incorporating earnout arrangements<sup>2</sup> in the acquisition of a private company.<sup>3</sup>

In an acquisition with earnout arrangement, the buyer will pay a substantial portion of the purchase price at closing.<sup>4</sup> The balance of the purchase price is contingent and will be delivered to the seller periodically during or at the end of a defined post-closing earnout period if the acquired business achieves certain milestones.<sup>5</sup> The milestones are generally financial benchmarks articulated in terms of the acquired business's post-closing net revenue, net income or cash flow. The contingent portion of the purchase price is, therefore, determined by the post-closing performance of the acquired business. An earnout allows the seller to monetize the future value of various operational variables and prospects of the business being sold. If the seller is confident in its projections, it may be willing to accept a smaller initial payment of the purchase price at closing in return for a workable earnout arrangement. This may be particularly important for a seller concerned about selling at a depressed price because of limited or poor historical results, periodic problems in the business or unrealized favorable prospects. In contrast, a buyer may be willing to pay a higher purchase price if it can hedge its risk that it has incorrectly valued the acquired business and its future prospects.

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<sup>2</sup> Earnouts are not purchase price adjustments. A purchase price adjustment is intended to adjust the purchase price after the closing. It reflects the difference between the pre-closing estimate of various financial measures of the acquired business that will exist at closing and the amount of the measure at closing. A purchase price adjustment may increase or decrease the negotiated purchase price.

<sup>3</sup> Earnouts in public company acquisitions are problematic because of the need to make multiple distributions post-closing to a large group of shareholders. However, through the use of an escrow and paying agent there is some opportunity to devise contingent payments with public companies particularly for a specific uncertain event such as a litigation recovery. Also, creative use of preferred stock may permit a payment that parallels an earnout. Finally, contingent payment rights ("CPR") may be devised to provide a stream of contingent payments in public company situations. CPRs provide a right to receive an event-driven contingent payment which delivers value to the sellers upon a positive outcome of an uncertain event.

<sup>4</sup> An earnout arrangement may be used regardless of the form of the acquisition.

<sup>5</sup> This article assumes the earnout will be paid in cash. Additional complications are raised if stock or other securities are used, including valuation of the security and securities laws considerations.

In addition to providing a mechanism to complete a transaction when the parties can not agree on valuation, an earnout may be attractive for various other reasons. If the seller continues in the business (hereinafter referred to as “seller-manager”), an earnout incentivizes the seller to continue to be involved in the acquired business and facilitate its smooth transition to the buyer.<sup>6</sup> For the buyer, an earnout provides a form of acquisition financing by reducing the amount of consideration delivered at closing and the costs associated with third party financing. If the buyer employs third party financing, these financing sources may take comfort the buyer has not over paid for the acquired business. An earnout arrangement may also provide the buyer a potential source for future indemnification claims by permitting the buyer to offset claims the buyer may have against the seller under the acquisition agreement’s indemnification provisions against future earnout payments.

In contrast to the potential advantages of an earnout arrangement, the seller and buyer must recognize certain risks posed by the arrangement. The seller-manager may not have sufficient control to manage the acquired business once it has been absorbed by the buyer to achieve the earnout formula. If the seller is not involved in the acquired business, then it runs the risk the buyer will not successfully manage the acquired business or manage the business in a manner that maximizes the earnout formula. From the buyer’s perspective, the earnout arrangement may incorrectly motivate a seller-manager to focus on short term goals as opposed

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<sup>6</sup> Significant accounting and tax issues can arise if the earnout is too closely linked to the seller-manager’s compensation. The issue is whether the earnout payment is part of the purchase price for the acquired business or is in substance compensation payments. Contingent purchase price payments are eligible for capital gain and installment payment treatment. Compensation payments are taxed as ordinary income. For the accounting profession’s view on this issue see EITF 96-8, *Accounting for Contingent Consideration Paid to Shareholders of an Acquired Enterprise in the Purchase Business Combination*. Among the factors identified in EITF 96-8 for accounting for the payment as contingent purchase price are (i) the reasons for the earnout provisions, (ii) the formula for determining the earnout, (iii) treatment of the earnout payments for tax purposes, (iv) linkage of

to a successful long-term strategy for the acquired business. A buyer may also be concerned the seller will benefit from an unforeseen windfall such as other acquisitions by the buyer or changes in the buyer's business plan unrelated to the acquired business that contribute to the earnout formula. Operating the acquired business under an earnout arrangement may also create distractions for the buyer and its efforts to integrate the acquired business into the buyer's overall enterprise. Finally, earnouts, in general, create opportunities for disputes and litigation about the interpretation of the earnout terms or the operation of the acquired business during the earnout period.

### **Structuring the Earnout Arrangement**

An earnout arrangement requires negotiation of the source of the earnout, the benchmarks to measure performance, a formula for calculating the payment amount and the period of time over which the earnout will be measured.

*Source of the Earnout.* To simplify the earnout structure and avoid calculation disputes, the buyer will often acquire the business with a newly formed subsidiary and maintain separate books and records during the earnout period. If the acquired business is integrated into an existing division or subsidiary, or the earnout is tied to a specific product line then the calculation of the earnout becomes more complicated and open for disputes; the buyer may have more opportunity to manipulate the financial performance of the acquired business to the detriment of the seller.

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payment of the earnout with continued employment (v) composition of the shareholder group, and (vi) the existence of other arrangements such as noncompete agreement and consulting agreement.

*Earnout Benchmarks.* One or more benchmarks must be selected to measure the post-closing financial performance of the acquired business.<sup>7</sup> These commonly take the form of measures of net revenue, net income, cash flow, earnings before interest and taxes (“EBIT”), earnings before interest, taxes, depreciation and amortization (“EBITDA”), and net equity thresholds. Net income may indicate the overall success of the acquired business on a GAAP basis. Alternatively, a seller may prefer a revenue-based measure, however, because it will not be affected by operating expenses and be less effected by accounting practices. A buyer, however, may argue that a revenue-based measure provides no incentive to control expenses. Some of these tensions may be bridged by using EBIT or EBITDA as benchmarks. Both measures measure the success of the operating business and reflect cost of goods, selling expenses and general and administrative expenses. However, they exclude interest, taxes, depreciation and amortization, which may vary based on the buyer’s tax position, capital structure or acquisition financing. An EBIT or EBITDA measure may also coincide with how the buyer initially valued the acquired business pre-closing so that EBIT or EBITDA become the logical measures to value the acquired business post-closing.

In selecting the benchmark, the parties must guard against potential distortions of the long term performance of the acquired business. A seller-manager may be more motivated to maximize the short-term success of the business over its long-term future. For example, investment in research and development, capital improvements or marketing may be in the long term interest of the business; a seller-manger, however, may attempt to reduce these expenses to

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<sup>7</sup> Non-financial benchmarks may also be used. In some industries with development-stage companies non-financial benchmarks may better measure the value of the acquired business. Non-financial measures include completion of a new product, getting a product to market or any number of uncertain events that have a positive outcome on the acquired business.

maximize short term revenue in an operating-based measure. Similarly, a seller-manger may be incentivized to book unprofitable business to enhance a revenue-based measure at the risk of impairing the long term success of the business. In contrast, the seller must be alert to actions a buyer could take that adversely impact the earnout formula. For example, increased depreciation or amortization resulting from any write-up of the value of the acquired assets, or interest and related charges from the acquisition financing will reduce income. These actions, however, could be neutralized by an EBIT and EBITDA benchmark.

*Formula for Payment.* The buyer will pay the seller either a stated amount if the benchmark is satisfied, or a specified percentage of the amount by which the acquired business exceeds the benchmark. The parties may also negotiate for adjustments to account for any shortfall in the benchmark achieved in a previous year. Prorated payments may also be made for a shortfall in achieving the benchmark. Sometimes the parties will establish a minimum hurdle before any payment may be made and, after the hurdle is achieved, a sliding scale or proration may be applied to calculate the payment to the seller. The aggregate earnout payable under the formula may also be capped to reflect an aggregate purchase price agreed upon at the time the acquisition agreement is executed.

If the buyer has financed the acquisition or incurs debt to finance the acquired business, post-closing, then a third party lender may seek to subordinate earnout payments to the terms of the third party financing. The lender will argue the earnout is a form of equity in the business and distributions of equity should stand behind repayment of indebtedness. In response to expected objections from the seller to subordination provisions, the buyer will argue the issue is out of its hands and without the financing no acquisition will occur. The seller, alternatively, may seek some further compensation for the additional risk of nonpayment.

*Earnout Period.* An earnout period generally extends over a two to five year period from the closing date. The amount of time anticipated to measure the projected value of the business will influence the time period selected; this may be a function of the respective projections developed by the buyer or seller. The parties may also select a period to parallel some other agreement such as an employment contract. The parties must evaluate the effect on the earnout period by events such as the sale of the acquired business, a change in control of the buyer, sale of the buyer or termination of the seller-manger's employment. Sometimes the parties will provide for a buyout of the earnout obligation upon occurrences of any of these events.

### **Calculation of the Benchmark and Accounting Issues**

Determination of the earnout will be derived from the financial books and records of the buyer. The seller should require the buyer to maintain separate books and records for the acquired business. This may entail separate financial statements for a division or subsidiary of the buyer depending on how the acquisition was structured. The seller should have access to these books and records for review or audit.

More complicated issues will arise if the acquired business is merged into another entity owned by the buyer. For these reasons the parties may be reluctant to structure the acquisition in a manner that fully integrates the acquired business with the buyer's other business units. Although this better facilitates the earnout arrangement, the delay of full integration may reduce the long term benefits of the acquisition to the buyer. Similar difficulties arise when the buyer makes future acquisitions of similar businesses. The parties must address how the acquired business financial statements will be segregated from the other businesses subsequently purchased by the buyer. This could likewise delay full integration of the subsequently purchased

business into the buyer's enterprise. A future acquisition may so complicate the calculation of the earnout formula that the buyer may negotiate to pay off the seller and eliminate the earnout arrangement. Alternatively, the buyer and seller may agree to combine the acquired business with the other business later purchased and formulate an allocation plan rewarding the seller a pro rata portion of the overall success of the combined business enterprise.

The parties must agree on the accounting principles to be used to calculate the benchmarks. The parties will often turn to generally accepted accounting principles ("GAAP"). Disputes could arise over the application of GAAP because GAAP embraces a wide range of acceptable accounting practices. Disputes regarding the calculation of the earnout often relate to the application of GAAP. The seller may be concerned with the buyer's ability to manipulate the results of earnout through adjustments to GAAP. At a minimum, unless otherwise provided in the agreement, the accounting for the acquired business post-closing should be applied in a manner consistent with the pre-closing accounting. For example, changing the method of inventory accounting post-closing from the pre-closing method could have a dramatic effect on the earnout calculation. Since GAAP interpretations are constantly changing, the parties may also desire to specify that changes occurring in GAAP post-closing will be ignored for purposes of calculating the earnout.

Regardless of the benchmark selected, the parties will need to consider whether certain adjustments or exclusions should be incorporated into the earnout formula to properly reflect the actual performance of the acquired business. Depending on the threshold used for the earnout, the seller should consider possible adjustments to the benchmark, including: (i) exclusion of all transaction related expenses; (ii) adjustments for depreciation resulting from the write-up of the

acquired business assets when a net income measure is utilized<sup>8</sup>; (iii) allocation of administrative or general overhead expenses; (iv) any acquisition financing, including any refinancing of such financing; (v) nonrecurring items of income, gain, loss or expense treated as “extraordinary” under GAAP; (vi) intercompany transactions between the acquired business and the buyer not at arms-length terms; (vii) losses or profits from the sale or acquisition of assets; (viii) costs or expenses directly relating to any restructuring, reorganization, or plant closing by the buyer; (ix) the earnout payments themselves; (x) depreciation charges relating to capital expenditures that exceed budget; (xi) administrative costs incurred to meet the specific accounting or regulatory requirements of the buyer; and (xii) fees and expenses arising from the acquisition. The buyer will have an equal interest in clarifying some of the foregoing adjustments as well. For example, the buyer will desire to exclude the impact of the acquisition of new assets that may be integrated into the acquired business and exclude “extraordinary” gains. More broadly, the buyer should consider adjustments for synergies arising out of the combination of the acquired business with the buyer’s existing business. Particularly if the buyer intends to use the acquired business as a platform for future acquisitions.

Other potential areas for accounting differences include inventory valuation methods, treatment of leases as operating leases or capital leases depreciations schedules, accounting for retirement and welfare benefits and reserves for bad debts.

One of the most discussed items relating to the topic of adjustments is the nature and amount of the buyer’s administrative and overhead expenses allocated to the acquired business.

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<sup>8</sup> Prior to the FASB’s adoption of SFAS No. 142, *Goodwill and Other Intangible Assets*, effective June 30, 2001, parties 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 goodwill acquired after June 30, 2001.

The approaches taken on this issue depend on the transaction and the negotiating leverage of the parties. The seller would prefer no deduction for any general overhead or intercompany charges on the theory the acquired business should be valued as a stand alone entity as it was prior to the acquisition. In response, the buyer may suggest that those overhead or administrative expenses incurred to replace services provided to the acquired business pre-closing should be allocated post-closing to the acquired business. These expenses may include general administrative expenses such as legal accounting, insurance, and occupancy expenses. Alternatively, the buyer may insist on a percentage allocation calculated in the same manner as the allocation to the other buyer's business units on the theory the acquired business benefits from integration with a larger enterprise which indirectly will contribute to its future success.

Earnout payments are sometimes subject to offset for indemnification claims by the buyer against the seller as provided under the acquisition agreement. If the buyer may offset against the earnout, the seller should require that the amount of any claim subject to offset must not be expensed (even if required under GAAP) against the benchmark measure selected by the parties.

### **Operation of the Acquired Business During the Earnout Period**

In *Horizon Holdings, LLC v. Genmar Holdings, Inc.*, the 10th Circuit applied the principles of good faith and fair dealing under Delaware law to uphold a jury finding that rewarded damages to the seller who the jury believed was deprived of an opportunity to achieve an earnout in the sale of a business. Horizon Holdings sold its boat manufacturing business to Genmar Holdings, Inc. for \$2.3 million plus up to \$5.2 million for an earnout based on gross

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Instead SFAS No. 142 requires an annual impairment test based on a comparison of the fair value of each reporting unit that maintains goodwill acquired to the carrying amount of the reporting unit's assets, including goodwill.

revenues and gross profit margins of the acquired business post-closing. The president and major shareholder of Horizon Holdings remained with the acquired business post-closing as president. He had been assured he would be given autonomy as president and that the earnout was a realistic achievement. The operations of the acquired business post-closing did not achieve the earnout benchmark which required a 13% percent gross margin.<sup>9</sup> The plaintiffs sued for the lost earnout asserting the defendants breach both the express terms of the agreement and the implied covenant of good faith and fair dealing associated with the acquisition agreement. More specifically, the seller claimed the buyer's course of conduct frustrated and impaired the seller's realization of the earnout.

The plaintiffs demonstrated that in addition to undermining the seller's authority, the buyer (i) changed the Horizon brand name; (ii) shifted manufacturing priority from Horizon products to the buyer's products; (iii) required Horizon at its cost to produce the buyer's own brands; (iv) reimbursed Horizon only for its actual costs for manufacturing the buyer's brands, which materially impacted the gross margin of the acquired business post-closing; (v) discontinued the Horizon brand of products; (vi) flipped Horizon dealers to other buyer brands; and (vii) closed Horizon's own manufacturing facility. None of these actions taken by the buyer were prohibited in the acquisition agreement.

Nonetheless, the court looked at the "obvious spirit" of the earnout arrangement to find that the seller should have been given a fair opportunity to operate the acquired business in a manner to maximize the earnout. With this in mind the court found the jury was reasonable to

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<sup>9</sup> The earnout formula provided for a five (5) year period and entitled the seller to future payments of the purchase price in an amount equal to a percentage of all annual gross revenues, subject to achieving certain gross profit

conclude that if the parties had they actually thought about it they would not have included provisions to permit the buyer to take the actions it took in the agreement. The court, therefore, upheld the district court finding that a fact finder could imply terms in an agreement to honor the spirit of the agreement when those obligations were omitted from the four corners of the contract and when the conduct taken is inconsistent with the spirit of the agreement. Such a determination according to the 10th Circuit is supported by the implied covenant of good faith and fair dealing:

“This implied covenant is a judicial convention designed to protect the spirit of an agreement when without violating the expressed terms of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties’ bargain.”<sup>10</sup>

The *Horizon Holding* case demonstrates the importance of expressing the parties expectations for the post-closing operation of the acquired business and incorporating those expectations into the provisions of the acquisition agreement. If the parties remain silent, the *Horizon Holding* case is an example of how a court will invoke good faith and fair dealing theories to determine what the parties would have intended had they thought about the issues in which they may have conflicting interests even if the conduct taken is not expressly prohibited by the acquisition agreement.

*Negotiation Issues.* Both parties must consider provisions in the acquisition agreement to address the type of post-closing problems identified in *Horizon Holdings*. The seller should

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percentages—15% or more the first year and 14% thereafter from the sale of seller’s products and manufacture of the buyer’s boats in one of the acquired business’ manufacturing plants.

negotiate for covenants to minimize the buyer's ability to make any significant changes in the acquired business during the earnout period that will impact the seller's opportunity to receive the earnout. The seller should consider covenants that the buyer will not (i) fail to operate the acquired business in the ordinary course and substantially consistent with the manner in which the business was operated prior to closing; (ii) make any material decisions material to the business without the prior consent of the seller; (iii) create any indebtedness other than liabilities arising in the ordinary course of business as currently being conducted and consistent with the business prior to closing; (iv) grant any security interests or liens on the assets of the acquired business; (v) cause the acquired business to guarantee any third party obligation including the buyer and its affiliates; (vi) pay dividends or make any distributions out of the earnings or assets of the acquired business until any earnout payments for the period have been paid; (vii) liquidate, dissolve, sell, lease or dispose of all or a substantial part of the acquired business or the buyer; or (viii) enter into any merger, joint venture or other business combination.

The buyer may attempt to resist limitations on its ability to operate the acquired business as circumstances arise. In this regard, the buyer should also make clear what obligations, if any, it has to the acquired business post-closing. The parties must discuss to what extent (i) the buyer will operate or participate in the operation of the business; (ii) the buyer must continue to manufacture the acquired business's products; (iii) the buyer will provide capital or financing to operate and grow the acquired business, and (iv) the buyer will have consent rights to approve material decisions effecting the acquired business. If appropriate the buyer should negotiate for acknowledgements from the seller that (i) the buyer has no obligation to operate the acquired business in a manner to maximize the earnout; (ii) there is no assurance the earnout will be

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<sup>10</sup> Horizon Holdings, LLC v. Genmar Holdings, Inc., supra at p. 1.

achieved and buyer has made no representations that the earnout will be achieved in full or in part, and (iii) buyer owes no fiduciary duty to the seller.<sup>11</sup>

## **Conclusion**

Earnout arrangements are an effective tool to allocate risk between a seller and buyer in the acquisition of a private company. Buyer and seller and their legal counsel must, however, carefully navigate around the thorny issues posed by earnout arrangements. Failure to craft appropriate provisions that take into account the parties' expectations may lead to disputes and litigation with the results left in the hands of a fact finder as demonstrated in the *Horizon Holdings* case.

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<sup>11</sup> See *Richmond v. Peters, et al.*, 166 F.3d 1215 (6th Cir. 1998) which held under Ohio law that an earnout agreement did not create an implied fiduciary duty between the seller and buyer.